



Government  
Actuary's  
Department

# Personal Injury Discount Rate regulation features advice

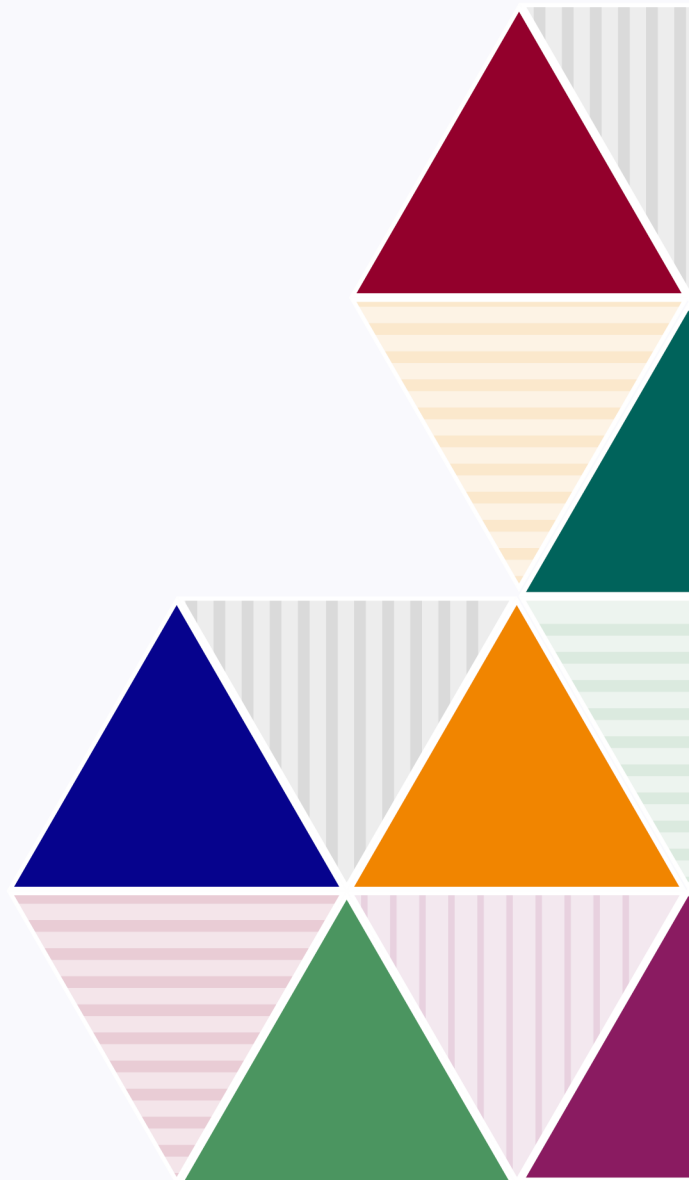
Scotland

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# Executive summary

The Personal Injury Discount Rate (PI discount rate) is used to determine lump sum damage awards to pursuers who suffer a serious personal injury.

In March 2019, Scottish Ministers passed the Damages (Investment Returns and Periodical Payments) (Scotland) Bill that set out changes to the way that the PI discount rate would be set in the future. The next review of the PI discount rate will begin by 1 July 2024. Prior to this review Scottish Ministers must consider whether the features of the rate setting methodology remain suitable.

The Government Actuary's Department have been asked to consider 5 questions relating to the current features of the regulation methodology, taking into account additional, readily available information since our previous advice.

Given the time that will elapse between providing this advice and the rate review, we cannot guarantee that all of the assumptions deemed appropriate at this time will still be appropriate in light of any new evidence that may be available when the rate review occurs.

## **1. Does the notional portfolio as provided in paragraph 12 of Schedule B1 remain suitable for investment in by a hypothetical investor as described in paragraph 17?**

**The notional portfolio is still suitable** – There has been no significant evidence to contradict previous analysis which informed the current notional portfolio. This assumption should be considered in conjunction with the investment period, to ensure the risk in the notional portfolio reflects the hypothetical investors investment horizon.

## **2. Does the assumed period of investment of 30 years, as provided in paragraph 7, remain appropriate?**

**A 30-year period is still appropriate** – This is a prudent approach which may reflect relatively short-term pursuers. However, we would also consider it reasonable to assume a hypothetical investor would invest over 43 years, in line with the Government Actuary's 2019 advice to the Lord Chancellor. This investment period was based on evidence gathered in the 2018 England and Wales Call for Evidence. This assumption should be considered in conjunction with the notional portfolio, to ensure analytical consistency.

## **3. Does RPI remain the most suitable reference for allowing for the impact of inflation under paragraph 9 and, if not, is there alternative 'published information relating to costs, earnings or other monetary factors' that we could prescribe in regulations under paragraph 9(2)(b)?**

**RPI is no longer suitable** – The change in the calculation methodology of RPI from 2030 means that it is no longer an appropriate index for damages inflation. Given the scope of the legislation as set out to us by the Scottish Government, a single index must be chosen and so a judgement must be made on what is considered to be most suitable. Additionally, we do not believe that there is a single index that provides a suitable assumption for damages inflation across all heads of loss.

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At a high level the choice is between a prices or an earnings inflation index. An earnings based index would potentially overestimate the inflation experienced in practice and a prices based index would potentially underestimate the inflation experienced in practice, assuming pursuers face a mix of heads of loss that are subject to both inflationary pressures.

**4. Do the standard adjustments provided in paragraph 10 (0.75% for the impact of taxation and the costs of investment advice and management; and 0.5% as the further margin) remain appropriate?**

**A deduction of 0.75% for taxation and investment costs is no longer appropriate** – Changes in investment yields and tax rates have increased the tax burden on pursuers by around 0.5% pa on average (noting this is highly sensitive to the individual pursuer). Investment costs are largely unchanged but there are some indications of higher costs. We believe a range of 1.0% to 3.0% is suitable for taxation and investment costs based on the evidence we have seen, we recommend a total adjustment at the lower end of this range, of 1.0% to 1.75%, to be consistent with the impact on the hypothetical investor.

**A deduction of 0.5% for the further margin is still appropriate** – We do not expect a significant change in the impact of the margin on the levels of under-compensation.

**5. Does current available evidence suggest that Scottish Ministers should consider making regulations under paragraph 21 to require that more than one rate of return should be set and, if so, to what circumstances should these rates relate?**

**A single rate is still appropriate** – Stakeholders are concerned about the introduction of a multiple rate system, due to the added complexity and the need for a transition period. A dual rate system may be appropriate, but we expect that further evidence and analysis would be required, and may not be possible to achieve in the current timeframes.

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# 1. Background and scope

## Background

The Personal Injury Discount Rate ('PI discount rate') is used to determine lump sum damage awards to pursuers who suffer a serious personal injury.

In March 2019, Scottish Ministers passed the Damages (Investment Returns and Periodical Payments) (Scotland) Bill that set out changes to the way that the PI discount rate would be set in the future. This led to a new rate being set in September 2019 at RPI -0.75%.

Under paragraph 2, Schedule B1 of the legislation, a review of the PI discount rate is required at least every five years. This review will begin by 1 July 2024. Under paragraph 16 of the same schedule, prior to this review Scottish Ministers must consider whether the features of the rate setting methodology remain suitable. As part of this requirement, in a letter dated 16 June 2023 reproduced in Annex C, the Justice Directorate of the Scottish Government asked the Government Actuary's Department (GAD) to provide an update to the analysis which informed the original methodology. This report should be read in conjunction with that original advice, 'Scottish Government: Personal Injury Discount Rate Analysis' dated 5 September 2018.

## Methodology

Based on the current methodology, the current rate was derived by summing the following items:

Item	% pa
Gross return above RPI inflation from notional portfolio before standard adjustments	RPI +0.50%
Standard adjustment for tax and costs of investment advice and management	-0.75%
Standard adjustment for further margin involved in relation to the rate of return	-0.50%
<b>PI discount rate</b>	<b>RPI -0.75%</b>

GAD have been asked to consider each feature of the methodology set out in the regulations in light of additional, readily available information since our last advice.

We have considered material relevant to the PI discount rate in Scotland, Northern Ireland, England and Wales. This includes previous GAD analysis, Calls for Evidence, requests for views and a desktop analysis of other readily available evidence. Where we have not seen any new evidence, we have assumed the current assumptions remain appropriate.

It is possible that new evidence may become available after this paper is finalised. This evidence could for example arise from the Expert Panel currently active in respect of the England and Wales rate review or through a change in the economic environment. As such, we cannot

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guarantee that all of the assumptions deemed appropriate at this time will still be appropriate in light of any new evidence available when the rate review occurs. We would be pleased to help the Scottish Government consider the potential impact of this, for example, in context of learnings for future rate reviews and in context of any rate set enduring for up to 5 years before the next review.

The request is set out below, with the components under review **bolded**.

The first three components determine the gross return from the notional portfolio:

1. Does the **notional portfolio** as provided in paragraph 12 of Schedule B1 remain suitable for investment in by a hypothetical investor as described in paragraph 17?
2. Does the assumed **period of investment** of 30 years, as provided in paragraph 7, remain appropriate?
3. Does RPI remain the most suitable reference for allowing for the **impact of inflation** under paragraph 9 and, if not, is there alternative 'published information relating to costs, earnings or other monetary factors' that we could prescribe in regulations under paragraph 9(2)(b)?

The next two components determine the standard adjustments to apply to that gross portfolio return:

4. Do the standard adjustments provided in paragraph 10 (0.75% for the impact of **taxation and the costs of investment advice and management**; and 0.5% as the **further margin**) remain appropriate?

The final component relates to how the methodology is applied in practice:

5. Does current available evidence suggest that Scottish Ministers should consider making regulations under paragraph 21 to require that **more than one rate of return** should be set and, if so, to what circumstances should these rates relate?

## Scope and limitations

This report is intended to provide illustrative analysis to the Scottish Government to inform their review of the suitability of the PI discount rate regulations. The report should not be directly or solely relied upon for the basis of determining the rate, nor does it provide a proposal of how the PI discount rate might be determined in the future.

We were asked to consider additional, readily available evidence. We have not provided a detailed, exhaustive review of each item. Based on our analysis and the available evidence, we do not believe that any material information is missing from this approach.

The Government Actuary has the statutory role as rate setter, so this report has been prepared by a separate team at GAD. The Government Actuary is aware of the conclusions and is content they are appropriate, based on conditions and information publicly available at this time.

Throughout this report we refer to previous analysis provided by GAD or the Government Actuary relating to the PI discount rate. This includes material produced for the Scotland review in 2019, the Lord Chancellor's review in 2019 and the Northern Ireland review in 2021. For full details of any analysis quoted please refer to these full reports. We also refer to certain Calls for Evidence

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and requests for views which have informed this paper and the previous papers above. A list of referenced material is set out in the Annex A with a short description, we can supply copies of this material on request where you do not currently hold it.

The analysis outlined above has been carried out in accordance with the applicable Technical Actuarial Standard: TAS 100 issued by the Financial Reporting Council (FRC). The FRC sets technical standards for actuarial work in the UK.

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## 2. Notional portfolio

**Does the notional portfolio as provided in paragraph 12 of Schedule B1 remain suitable for investment in by a hypothetical investor as described in paragraph 17?**

The notional portfolio determines the composition of the investment portfolio held by the pursuer. It is intended to reflect a hypothetical investor defined in the legislation. The current notional portfolio is shown in the table below.

<b>Asset class</b>	<b>Allocation</b>
<b>Cash or equivalents</b>	10%
<b>Nominal gilts</b>	15%
<b>Index-linked gilts</b>	10%
<b>Investment-grade credit</b>	30%
<b>High-yield bonds</b>	5%
<b>UK equities</b>	7.5%
<b>Overseas equities</b>	12.5%
<b>Property</b>	5%
<b>Other types<sup>1</sup></b>	5%

The key sources of evidence to consider whether the notional portfolio remains appropriate are the analysis presented in the responses to the request for views, the 2019 advice to the Lord Chancellor, and the currently available 'low risk' investment funds. None of these sources of data can directly dictate the appropriate assumption, however they provide some indication of an appropriate investment portfolio. Further, the economic outlook has changed considerably from that of the last rate review, and the outlook remains volatile, which makes determining an appropriate assumption for the next five years more challenging.

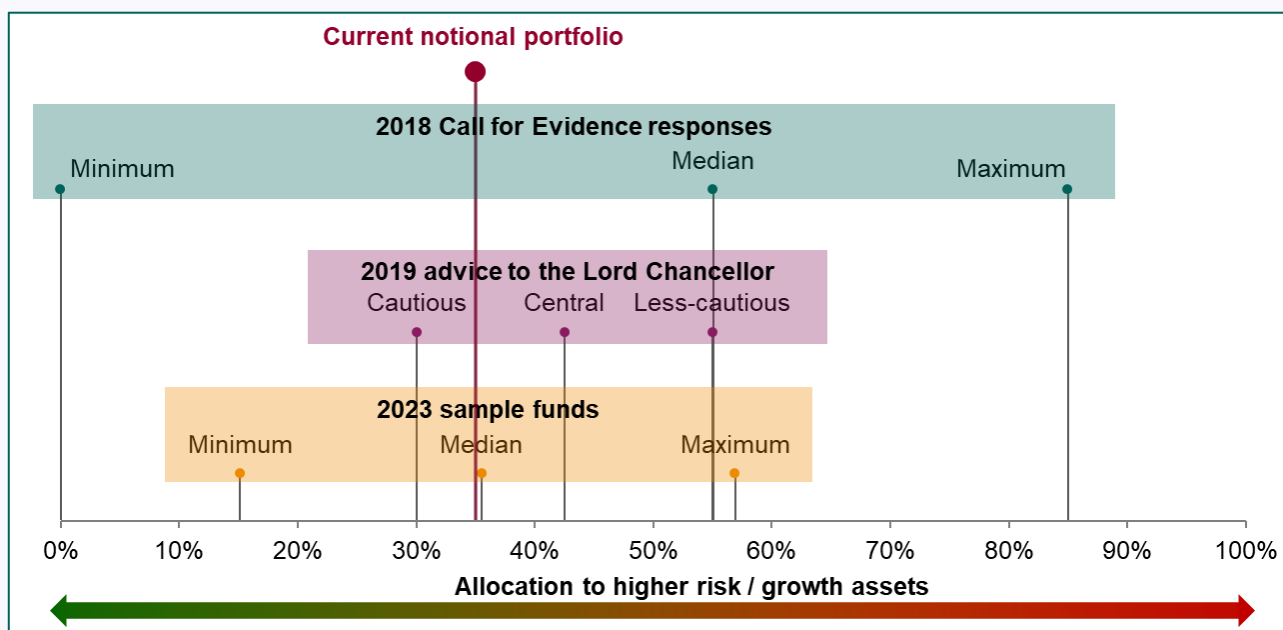
The figure below presents a summary of the relevant information.

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<sup>1</sup> Examples include infrastructure, commodities, hedge funds and absolute return funds



Figure 1: Allocation to higher risk / growth assets across portfolios



Given the lack of evidence contradicting the current notional portfolio, it appears appropriate to retain the current assumption.

The notional portfolio assumption should be considered in light of the chosen investment period discussed in the next chapter, as the risk appetite of pursuers will likely depend on their investment horizon. While the current notional portfolio is likely appropriate under both a 30 and a 43 year investment period, if the investment period is increased, that may make it more appropriate to consider a higher risk portfolio.

## Background

Depending on their individual circumstances, pursuers choose different investment strategies and therefore invest in a range of portfolios, each with different levels of risk. All else equal, a pursuer investing in riskier investments might be expected to earn a greater return, but that return would be more uncertain.

When considering pursuer investment portfolios, one might consider how pursuers should invest their damages, are advised to invest their damages, and actually invest their damages. However, there is limited evidence available on this, and any data would reflect past behaviours and not necessarily reflect the latest economic outlook. In the Scottish legislation the only requirement is to consider a hypothetical investor, who we understand is assumed to be cautious.

In the 2018 Scotland report, funds were analysed that were categorised as ‘low risk’ by [Morningstar](#). This is a third-party investment research firm that is widely recognised across the investment management industry.

For this analysis a sample of 20 funds were selected, broadly based on the size of their assets under management. These were the funds with the largest amounts of assets under management, when compared with all the other ‘low-risk’ funds. The available fund documentation for each of

the funds was then used to understand their respective asset allocations. This led to the current notional portfolio.

This analysis was later revalidated in the 2020 Northern Ireland memo through a sample of 5 of the funds.

## England and Wales

In the 2019 advice to the Lord Chancellor market information was considered alongside the 2018 Call for Evidence responses. These considerations focused on the split between growth assets, expected to generate higher returns at greater risk, and matching assets, expected to generate lower returns at more certainty. The central and cautious portfolios derived from this analysis are shown below and compared to the current notional portfolio.

	England and Wales Central	England and Wales Cautious	Scotland Notional portfolio
<b>Lower risk / matching assets</b>	<b>57.5%</b>	<b>70%</b>	<b>65%</b>
<b>Cash or equivalents</b>	10.0%	12.5%	10%
<b>Gilts</b>	30.0%	35.0%	25%
<b>Corporate bonds</b>	17.5%	22.5%	30%
<b>Higher risk / growth assets</b>	<b>42.5%</b>	<b>30%</b>	<b>35%</b>
<b>Equities</b>	32.5%	22.5%	20%
<b>Alternatives<sup>2</sup></b>	10.0%	7.5%	15%

The England and Wales portfolios were intended to show a reasonable range and this comparison shows that the current notional portfolio is broadly half way between the central and cautious portfolios in terms of overall risk. The exact allocation is slightly different to the England and Wales portfolios, with more corporate bonds compared to gilts and fewer equities compared to alternatives.

The evidence supplied and the portfolios chosen for England and Wales may not be directly applicable to the notional portfolio for Scotland. This difference is due to the legislative definitions of the investor and the time that has passed since the England and Wales rate review.

In all jurisdictions the investor is assumed to receive a lump sum, be properly advised, have no other income to fund their damages (and so aim to fund all losses through their awarded damages), and aim to exhaust their fund at the end of the award period.

In England and Wales further restrictions apply beyond this, importantly the portfolio must contain a level of risk that is more than very low but less than an ordinary prudent investor, and it must reflect the actual investments made by pursuers and the returns available to them. Beyond this the rate setting process is more flexible in England and Wales, as the Lord Chancellor makes the final rate determination.

<sup>2</sup> This includes high-yield bonds, property and other types from the notional portfolio

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In Scottish legislation the hypothetical investor is not defined beyond the constraints set out above. However, the policy memorandum which accompanied the bill described the hypothetical investor's portfolio as 'cautious' and taking 'an approach... limiting volatility and uncertainty'. This suggests a broadly similar level of risk to that taken in England and Wales, and means this evidence is a useful comparator for the notional portfolio.

The evidence underlying the England and Wales analysis may also be considered out of date. This is because of the changes in economic conditions since this evidence was gathered, additionally a review is ongoing in England and Wales which may supersede this evidence. Therefore caution is required when considering the applicability of their portfolios, we have used them as one of a number of reasonableness checks.

## Joint request for views

In the 2023 joint request for views stakeholders expressed views on the notional portfolio allocation. Largely, pursuer representatives took the view that the current portfolio is too risky, and doesn't reflect the requirement for pursuers to hold cash to pay for costs. While defender representatives stated that the central portfolio used in the 2019 advice to the Lord Chancellor is more appropriate, as they believe pursuers hold more equities in practice.

Both stakeholder groups pressed for more evidence gathering in order to ensure that the portfolio reflects actual pursuer behaviour. These views largely reflect the evidence supplied in the 2018 Call for Evidence.

## Updated analysis

To determine whether the 20 low risk funds previously analysed to derive the notional portfolio have changed, we repeated the analysis based on current allocations. We did not rely on a sample for this exercise due to the significant changes in the market since the initial analysis in 2018 and revalidation in 2020.

Morningstar has changed their categorisations since 2019, with these funds previously categorised as 'low risk' now largely falling into the 'GBP Allocation 0-20% Equity' and 'GBP Allocation 20-40% Equity' categories. One fund is now classified as 'GBP Allocation 40-60% Equity' as so was excluded for no longer being low risk, and one fund was no longer available for analysis. This left 18 portfolios, the analysis of these is shown below compared to the 2018 analysis.

Asset class	Notional portfolio (%)	2018 average (%)	2023 average (%)	Change (%)
<b>Lower risk / matching assets</b>	<b>65</b>	<b>65</b>	<b>63</b>	<b>-2</b>
Cash or equivalents	10	9	4	-5
Nominal gilts	15	16	18	2
Index-linked gilts	10	4	5	1
Investment-grade credit	30	35	35	0
<b>Higher risk / growth assets</b>	<b>35</b>	<b>35</b>	<b>37</b>	<b>2</b>
High-yield bonds	5	7	9	2
UK equities	7.5	7	6	-1
Overseas equities	12.5	12	14	2
Property	5	5	1	-4
Other types	5	5	8	2

Note that, as when this analysis was carried out previously, the proposed allocation relies on a significant level of judgement and is subjective in that:

- Different interpretations of the allocations across the 20 sample funds could lead to alternative proposed allocations. Judgement was required and asset class labels were not always clear or consistent across the funds. This is particularly true for smaller asset classes that may fall into other categories, such as property.
- The allocations depend on the sample of funds included in the analysis and that sample is relatively small.
- The allocations reflect one possible representation of a 'low risk' fund, there are many ways that the asset classes could be blended to deliver a broadly similar level of expected risk and return.

This updated analysis shows that there have been some changes in average portfolio composition. This is broadly summarised as a reduction in property and cash holdings, and an increase to gilts, bonds and equities.

The change in property could be the result of a real shift in fund investments, however it is also an asset class that is not always declared clearly in fund statements, meaning it may be underrepresented in our analysis (for example investors can access property through equities, as well as property funds). There is an increase in other risky assets however, such as overseas equities and other types of assets, which balances the decrease in property held. Given the assumed returns for these asset types are very similar, this change would not significantly impact expected returns for investors.

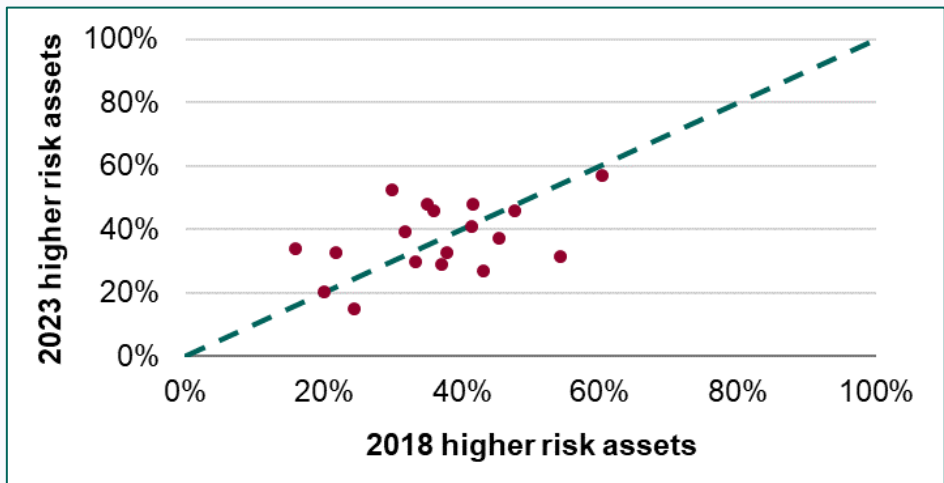
The reduction in cash allocations could be due to the current high levels of inflation, which makes holding cash is less attractive, and recent market movements making gilts a more attractive investment relative to cash. As gilts are expected to provide returns at a very similar rate to cash (over the long term), this change would not significantly impact expected returns for investors.

Overall the split between lower and higher risk assets is very similar. Therefore, while we see some movement between asset classes, we are not seeing significant changes in the overall split

between lower risk / matching assets and higher risk / growth assets, and therefore changes to the portfolio to reflect the above movements, would not significantly impact expected returns for investors.

The figure below demonstrates this consistency in risk taking overall. We can see that while the percentage of higher risk assets has increased for some funds (those above the dashed line) it has decreased for around the same number of funds (those below the dashed line).

Figure 2: Change in sample fund percentage higher risk assets between 2018 and 2023



While the individual fund differences outlined above are relatively large, there does not appear to be significant evidence here of a systemic change, that would suggest that the notional portfolio is no longer appropriate.

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## 3. Investment period

### **Does the assumed period of investment of 30 years, as provided in paragraph 7, remain appropriate?**

The investment period determines the length of time the pursuer is assumed to invest their fund and pay damages over. The current investment period is 30 years.

There is no approach to setting the investment period which would be fair for every future pursuer. The choice is likely to be a consideration of whether to set the discount rate with regard to the 'average' pursuer, or alternatively whether to take into consideration pursuers with different investment horizons.

For instance, it was noted by respondents in the 2018 Call for Evidence that although many claims are indeed for a longer period, considering a 30-year investment period provides some protection to pursuers with shorter time-horizons, who are more likely to face the risk of lower investment returns over these periods.

Additionally, once an investment period is set, it will be important to ensure consistency with other assumptions, in particular the notional portfolio, as described in the previous chapter.

As such:

- Setting a 43-year investment period might be appropriate in order to set the legislation with respect to the median pursuer, in line with the new evidence provided for the 2018 Call for Evidence (most significantly further information from the Association of British Insurers and NHS Resolution).
- Setting a 30-year investment period might remain appropriate, if some consideration is to be given to pursuers who are investing over a shorter term than the average.

The notional portfolio assumption should be considered in light of the chosen investment period, as the risk appetite of pursuers will likely depend on their investment horizon. However, both the current notional portfolio and the England and Wales portfolio could be viewed as appropriate under either a 30-year or 43-year investment period.

### **Background**

Given that the PI discount rate is intended to reflect the expected investment return a pursuer might earn on their lump sum award, the investment period should reflect the period over which pursuers are investing. For many personal injury claims, this is likely to be linked to the pursuer's life expectancy (assuming that damages are incurred for the rest of their life), but in some cases a different period might be suitable (where damages are limited in time, such as short-term rehabilitation).

There is a very wide range of personal injury claims, and these 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.

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When setting the original assumption of 30 years there was limited data available on the life expectancy and investment period for personal injury pursuers. This led to this assumption being taken forward in the absence of any contradictory evidence, which was thought to be a reasonable central assumption between a short period of ~10 years and a long period of ~50 years.

We are aware that the Association of British Insurers did supply evidence on life expectancy when the bill was being considered in the committee stage<sup>3</sup>. This set out that the average life expectancy following a serious personal injury claim with damages over £250k was 46 years. The Scottish Parliament did not consider this sufficient evidence to change the investment period assumption.

One of the key considerations in setting the investment horizon is likely to be the impact that it has on different pursuers. In the Government Actuary's 2019 advice to the Lord Chancellor, the choice of the investment horizon had a relatively large impact on the resulting discount rate (assuming a target of 50% likelihood of sufficient compensation). The central analysis showed a discount rate of around CPI +0.25% pa for a pursuer with a 43 year investment period, compared to around CPI -0.75% pa for a pursuer with a 10 year investment period.

Largely, this was because the investment horizon determines the investment strategy available to a pursuer, for example a longer investment horizon could allow for them to invest a larger proportion of their fund in growth assets. However, there was also a small impact from investment returns being projected to be lower in the short-term and higher in the longer term. Current market conditions suggest less variation in returns at different time periods compared to the previous review, however we cannot say what projections will look like when the Government Actuary produces their report.

## England and Wales

As part of the 2018 Call for Evidence, evidence was submitted that the typical life expectancy of personal injury pursuers is around 40-45 years. This information was not specific to Scotland and included data from the Association of British Insurers (which was more detailed analysis compared to the evidence previously supplied, discussed above) and NHS Resolution (the body which manages NHS clinical negligence claims).

Given the broad range of evidence suggesting a similar figure, this led to an assumption of 43 years in the 2019 report to the Lord Chancellor, and this was then also adopted in the Northern Irish regulations based on the same evidence. Analysis in the 2020 Northern Ireland memo demonstrated that the difference between expected returns over 43 years and 30 years was around 0.1% to 0.2% at the time that the assumptions were set, holding everything else constant, including the investment strategy.

## Joint request for views

The responses to the 2023 joint request for views did not provide any additional information to inform the choice of investment period, with pursuer representatives arguing for the shorter period of 30 years (which would result in a lower discount rate and higher awards for pursuers) and

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<sup>3</sup> See [https://archive2021.parliament.scot/S5\\_EconomyJobsFairWork/Inquiries/20181123-Association\\_British\\_Insurers.pdf](https://archive2021.parliament.scot/S5_EconomyJobsFairWork/Inquiries/20181123-Association_British_Insurers.pdf)

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defender representatives arguing for the longer period of 43 years (which would result in a higher discount rate and lower costs for defenders).



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## 4. Damages inflation

**Does RPI remain the most suitable reference for allowing for the impact of inflation under paragraph 9 and, if not, is there alternative ‘published information relating to costs, earnings or other monetary factors’ that we could prescribe in regulations under paragraph 9(2)(b)?**

Damages inflation determines the allowance for the impact of cost growth on the value of investments. The current damages inflation assumption is the Retail Prices Index (RPI). The methodology used to calculate RPI is planned to change in 2030 to align with the Consumer Prices Index including owner occupiers' housing costs (CPIH).

While previously when setting the discount rate the Government Actuary projected RPI using the current methodology for the entire period, this is now much less defensible, as the legal challenge against the RPI methodology change has been dismissed. This means that if RPI is retained as the damages inflation assumption, the Government Actuary would need to determine the appropriate approach, satisfying both their legislative and professional requirements. If this meant allowing for the change in methodology, these projections would include a step change in 2030 when the methodology changes. As CPIH is projected to be lower than the current RPI methodology, the impact of this would be pursuers receiving less compensation.

As set out below, previous consideration of the rate of damages inflation has concluded that RPI under the current methodology (which is broadly accepted to be around 1% above the Consumer Prices Index (CPI)) is appropriate. This is because damages are subject to both prices inflation and earnings inflation, and CPI +1% is expected to fall between these two rates.

We note that the legislation in Scotland requires a single, unadjusted, published index to represent damages inflation. Therefore, options such as making an adjustment to CPI ie CPI + X%, the publication of a bespoke index or using the further margin to adjust for inflation were deemed to be not possible under the legislation and have not been considered further.

### Choose the best index available

There are many measures of inflation available, including prices inflation measures (CPI and CPIH) as well as earnings inflation measures (Average Weekly Earnings (AWE) and earnings in the Annual Survey of Hours and Earnings (ASHE) discussed below). Compared to long-term projections of RPI under the previous methodology, equal to around CPI +1%, these measures would likely be higher or lower, as shown in the table below.

Index	Long-term projection reasonable range
CPI	2.0% to 2.4% pa
CPIH	CPI + 0.0% to 0.1% pa
AWE	CPI + 1.5% to 1.8% pa

Whatever index is chosen, the Government Actuary will use all available evidence at the time of the rate review to determine an appropriate long-term projection. We cannot confirm what the

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specific rate of damages inflation will be, due to potential changes in the economic environment prior to the review and the judgement required in deriving projections.

Long-term projections of ASHE and subsets of ASHE, such as care workers earnings, are not readily available, but would be broadly expected to align with AWE. If required, GAD can provide additional analysis comparing projections of CPI to projections of ASHE, including consideration of different subsets of ASHE data.

Overall the average rate of inflation faced by pursuers is likely to fall between prices and earnings inflation, as set out below. Therefore, we expect an earnings based index would potentially overestimate the inflation experienced in practice and a prices based index would potentially underestimate the inflation experienced in practice.

There is very limited information available on the split of claims by different heads of loss and the inflation measures that are most applicable. This means we are unable to present any analysis of the damages inflation experienced by pursuers to inform this decision.

It is also worth noting that, as there are not any indices designed to reflect damage inflation, any index referenced in legislation will not have been designed for that purpose. Therefore, when referencing an existing index, a judgement is being made as to an appropriate reference point for damage inflation, based on consideration of the available evidence.

## **Heads of loss**

If a multi-rate approach split by heads of loss was adopted, then a different index could be used for different heads of loss. While this option is technically attractive, it is not as simple as those presented above in terms of how it would be constructed and documented, as there won't always be a direct link between a head of loss and a published index.

Under an approach split by heads of loss, you would establish different damage inflation assumptions for groups of heads of loss. This could mean assuming that increases in damages related to consumer prices are linked to CPI, while earnings related damages are linked to an earnings inflation index. This would not perfectly match the inflation faced by all heads of loss, however it would result in a better fit than a single index. As a multi-rate approach, this would also involve additional practical difficulties and complexities that would need to be worked through. Please see the chapter on dual or multi rates for more details on these concerns.

Given the additional issues concerning a rate split by heads of loss, it appears that choosing a single index may be more appropriate.

## **Inflation background**

The rate at which a pursuer's damages inflate over time influences the sufficiency of their settlement to meet their needs, with a higher assumed inflation meaning pursuers require a larger fund. While a pursuer may have a fair degree of certainty on the level and cost of damages in the near-term, over time these would be expected to increase owing to the effect of inflation.

By assuming that damages inflate in line with RPI, to the extent that the actual cost increases turn out to be higher or lower than this assumption pursuers will either lose or benefit due to this difference.

The assumed RPI damages inflation was carried forward from the previous PI discount rate legislation. As set out below, this was thought to be an appropriate measure as it is generally expected to be higher than consumer inflation but lower than earnings inflation.

On 25 November 2020, the UK Statistics Authority (UKSA) and the UK Government issued a response to their joint consultation on aligning the methodology of RPI more closely with the methodology of CPIH. Their response confirmed the following:

- The UKSA confirmed its policy to implement the change at the earliest possible time it could.
- The Chancellor does not consent to the alignment of RPI with CPIH before 2030.

Previous Government Actuary rate reviews for Scotland and Northern Ireland have projected RPI under the current methodology. This was based on uncertainty in the policy or its exact implementation due an ongoing legal challenge, which has now been resolved.

In the 2019 advice to the Lord Chancellor, CPI was used to model damage inflation. This was adjusted by a +1% margin, which resulted in a measure of inflation broadly equivalent to RPI under the current methodology. This CPI +1% assumption was based on views in the 2018 Call for Evidence. The arguments relevant to your considerations are summarised in the table below.

Measure	Reasons in favour	Reasons against
<b>CPI</b>	<ul style="list-style-type: none"> <li>• Headline level of inflation</li> <li>• Representative of ‘cost of living’</li> <li>• A minority of care costs may be linked to this</li> <li>• Appropriate if we believe that pursuer only has limited needs that inflate with earnings</li> </ul>	<ul style="list-style-type: none"> <li>• Other care costs, including nursing, may be expected to inflate at a higher level (earnings)</li> </ul>
<b>Earnings</b>	<ul style="list-style-type: none"> <li>• Some care costs, including nursing, and loss of earnings likely to be linked to this</li> <li>• Appropriate if we believe that most of pursuers’ needs inflate with earnings</li> <li>• Would be consistent with the approach taken in Periodical Payment Orders</li> </ul>	<ul style="list-style-type: none"> <li>• Will overstate inflation for ‘core’ consumption needs and other care costs</li> </ul>

## Joint request for views

The responses to the 2023 joint request for views were largely unanimous in that RPI was no longer a suitable measure of inflation, and the base index should change to CPI. There was disagreement around the adjustment to apply to CPI however, with a core range of CPI +0% to +1%. The request for views did not specify potential constraints around the application of using CPI plus an adjustment, or specifically invite views on other inflation measures.

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## Measures of inflation

There are five key measures of prices and earnings inflation that are relevant if a single inflation index is required to reflect damages inflation:

- **RPI** – The Retail Prices Index (RPI) measures price inflation. It was historically used to index legislation in line with inflation, but is no longer an official statistic and is being aligned with CPIH from 2030.
- **CPI** – The Consumer Prices Index (CPI) measures price inflation. CPI was introduced as a method to measure price inflation in line with international standards. It is the measure used in the government's target for inflation and is used to index government benefits such as public sector pensions.
- **CPIH** – The Consumer Prices Index including owner occupiers' housing costs (CPIH) measures price inflation, including costs associated with owning, maintaining and living in one's own home. RPI will be aligned with this index from 2030.
- **AWE** – The Average Weekly Earnings index (AWE) is a measure of earnings per employee. This reflects both pay rises and changes in hours worked. It is the measure used to reflect earnings in the state pension triple lock. This is calculated based on a sample of businesses in Great Britain.
- **ASHE** – The Annual Survey of Hours and Earnings (ASHE) produces a collection of measures relating to earnings in the UK.
  - **ASHE All 50<sup>th</sup> percentile** – ASHE All reflects all workers in the UK, and the 50<sup>th</sup> percentile reflects the average worker.
  - **ASHE 6115 80<sup>th</sup> percentile** – ASHE 6115 reflects care workers specifically, and the 80<sup>th</sup> percentile of this is the index most commonly used for periodical payment orders.

Comparing AWE, ASHE All and ASHE 6115, it could be argued that ASHE 6115 is a more appropriate index to use, as it is a better measure of damages inflation related to care worker wages. However, only a minority of heads of loss are related to care worker wages, meaning that the other more general indices may be more appropriate to reflect heads of loss such as future earnings.

There are also regional ASHE figures which may be a more appropriate index to use. However, the damages inflation assumption is not necessarily intended to reflect wages in Scotland, as pursuers may in reality experience damages inflation across their heads of loss more in line with UK wide earnings inflation. Additionally, not all pursuers will be working in Scotland, and therefore not all pursuers will be sensitive to Scottish earnings inflation. If there is any reason to believe that earnings inflation in Scotland is significantly different to the rest of the UK, this may mean it is more appropriate to use an earnings index specific to Scotland.

There may also be further challenges in forecasting the more granular ASHE indices, as we would expect fewer market commentators to refer to more niche indices and a smaller pool of data may mean increased volatility. We understand part of the attraction for using RPI previously was because it is widely commented on and a market-implied inflation forecast can be inferred from index-linked gilt prices.

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To note, AWE is only based on a sample of Great Britain whereas ASHE is based on UK wide data. However, given the population of Northern Ireland is relatively small compared to the rest of the UK, this is unlikely to lead to a material difference between a Great Britain and UK wide sample.

The ONS has also published some guidance that informs consideration of the practicalities of producing projections of damage inflation under each option<sup>4</sup>. Firstly, as ASHE relies on a larger sample size, it is useful for considering accurate levels of pay at a point in time, this also means more granular indices are available (as discussed above). On the other hand, AWE is produced more regularly than ASHE, and is therefore better when considering rates of change, ie measuring the change in earnings over time.

The ONS also highlights that AWE is 'revised' back to 2000, in comparison to ASHE which has 'discontinuities'. This means that the methodology used to calculate these indices has changed over time. Without adjustment, this could result in analysis of the indices over the whole period to be skewed by methodological changes that are unrelated to changes in actual earnings. No correction is made for this in the ASHE data (other than both versions of the results being published in each year when the methodology changes). Whereas historical AWE is recalculated back to 2000 whenever the methodology changes, to give a continuous measure over the whole period.

The above considerations suggest AWE may be more appropriate than ASHE All, if the intention is to project future rates of change, as having regularly and consistently produced historic data better supports the production of long-term projections.

Given the potential for uncertainty if ASHE was referenced without further context in the legislation, we would recommend explicitly referring to the aspect of ASHE intended (eg all workers, care workers, etc). The Government Actuary is required to interpret any ambiguity in line with the most likely intention of the legislation.

## History

The relative changes in the measures of inflation over time are not constant, as they all measure different things. The figures below show the historical rates since 2001, relative to CPI.<sup>5</sup>

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<sup>4</sup><https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/articles/anoverviewofandcomparisonbetweenannualsurveyofhoursandearningsasheandaverageweeklyearningsawe/2017-09-14#:~:text=ASHE%20has%20a%20higher%20degree,capturing%20accurate%20levels%20of%20pay.>

<sup>5</sup> CPI ([D7G7](#)), CPIH ([L550](#)), RPI ([CZBH](#)) and AWE ([KAB9](#)) as at 1 April in year X. [ASHE](#) (tables 1.5a and 26.5a respectively, hourly pay – gross, percentiles as above) as at financial year X-1/X.

Figure 3: Historical price inflation rates, in excess of CPI, since 2001

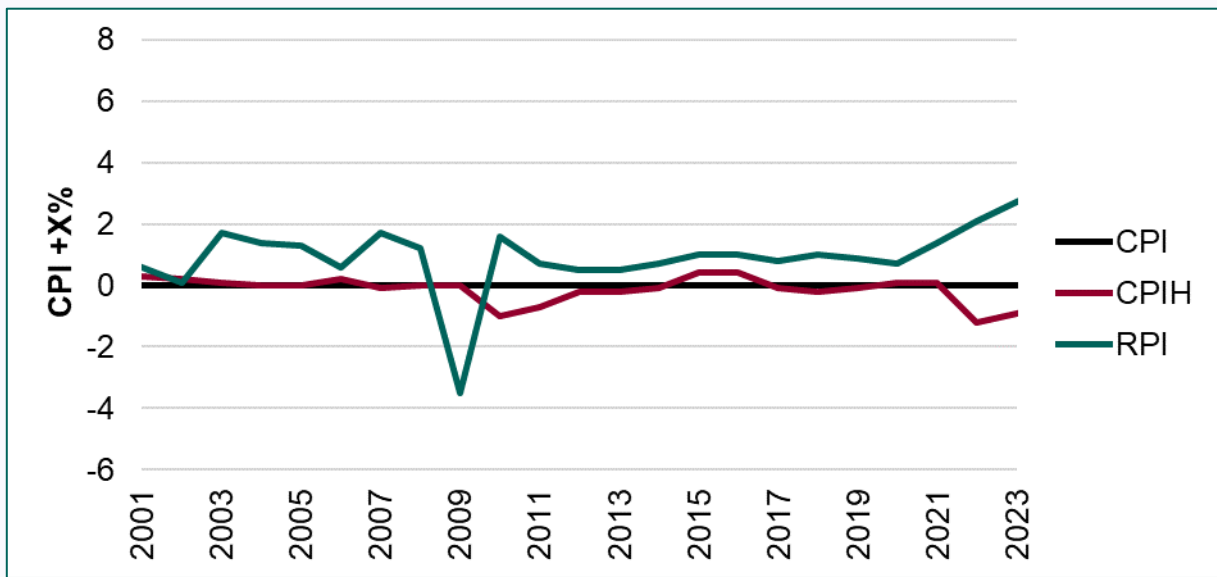


Figure 3 above, shows that CPIH has historically been very similar to CPI, as would be expected. There is no clear bias above or below CPI, it can be both higher and lower depending on how housing costs compare to general inflation. RPI on the other hand has been consistently higher than CPI, barring the effects of the 2008 financial crisis. RPI has tended to be around 1% above CPI, which has largely due to the different formulae used in the composition of the indices. Both measures track relatively close to CPI in comparison to the spread of earnings inflation shown in Figure 4 below.

Figure 4: Historical earnings inflation rates, in excess of CPI, since 2001

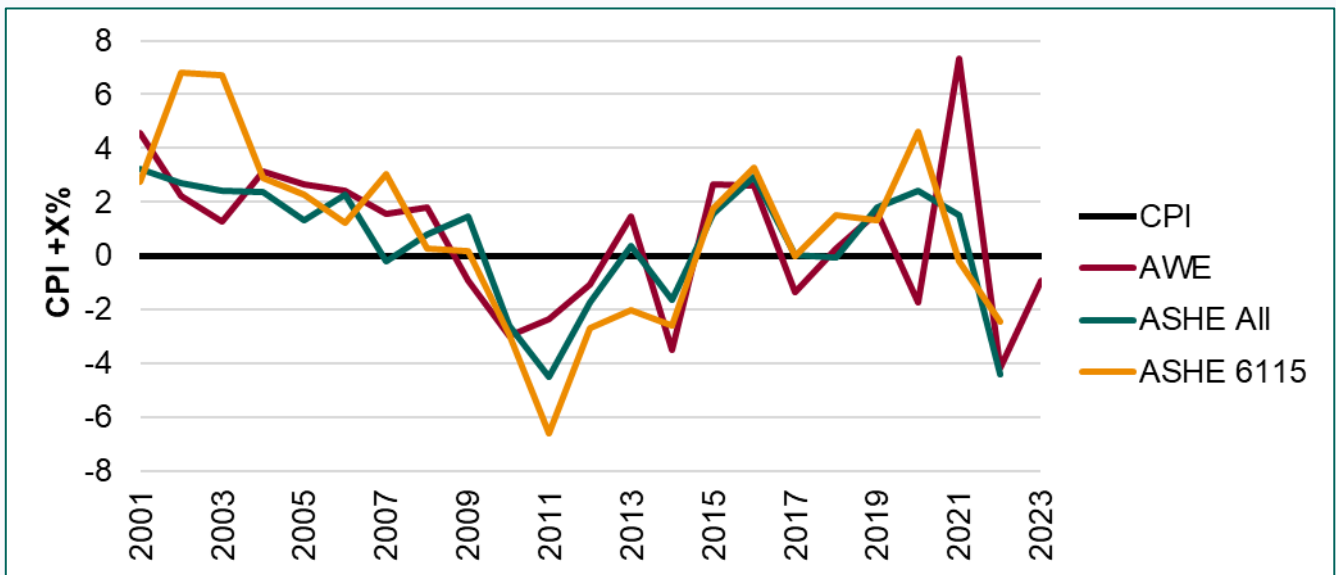


Figure 4 above shows that all measures of earnings inflation have fluctuated around CPI since 2001, largely in the same direction. ASHE 6115 is generally the most different from CPI, and this is discussed in detail below:

- Up to 2010, ASHE 6115 increases were on average 2.3% pa higher than CPI increases. From 2010 to 2015, there was a period of low wage inflation and ASHE 6115 increases were on average 2.5% pa below CPI.
- Since 2015 wage increases have been growing and ASHE 6115 increases were, on average, 1.2% pa higher than CPI inflation.
- In the most recent year with ASHE data (2022), the ASHE 6115 increase was lower than the CPI increase by 2.4%. This is most likely driven by higher short-term CPI (due in part to recent energy price increases) not being yet matched by wage increases.
- Across the entire period considered, ASHE 6115 has been, on average, 0.9% pa above CPI.
- AWE and ASHE All have followed a similar trend to ASHE 6115. Across the entire period AWE has been on average 0.7% above CPI, while ASHE All has been 0.5% above CPI. This contrasts with higher earnings inflation seen in earlier periods. In their 2019 advice to the Lord Chancellor, the Government Actuary derived a long-term earnings growth assumption of CPI +2% based on evidence since 1970.

### Long-term assumptions

The figures above demonstrate the historical growth rates of these indices, however when setting the PI discount rate, the damage inflation will be projected forward over the investment period. Therefore, below we have set out relevant long-term projections from the Office for Budget Responsibility (OBR) and GAD.

We do not present any views on long-term RPI, as this will be aligned with CPIH. We also do not present long-term views on either ASHE index, as these are not readily available. GAD are able to produce this analysis if required.

The GAD projections are taken from our in-house pensions valuation advisory guidance. As a result, they may not be fully consistent with the rest of the discount rate methodology. However, in our view they provide a reasonable indication of current long-term projections in line with the discount rate methodology.

The figures below should be taken as illustrative ranges, which indicate potential assumptions the Government Actuary could make in their review.

	Long-term assumption comparisons	
Index	OBR <sup>6</sup> (as at July 2022)	GAD (as at Sept 2023)
CPI	2.00% pa	2.40% pa
CPIH	CPI +0.00% pa	CPI +0.10% pa
AWE <sup>7</sup>	CPI +1.80% pa	CPI +1.50% pa

<sup>6</sup> <https://obr.uk/frs/fiscal-risks-and-sustainability-july-2022/>

<sup>7</sup> Neither the OBR nor GAD produce AWE specific assumptions, these reflect overall earnings inflation projections

## 5. Taxation and investment advice

**Do the standard adjustments provided in paragraph 10 (0.75% for the impact of taxation and the costs of investment advice and management; and 0.5% as the further margin) remain appropriate?**

A standard adjustment is required to reflect that pursuers face costs associated with the investment of their fund. The current standard adjustment for tax and costs of investment advice and management is 0.75% pa.

The appropriate allowance for tax and investment costs is likely to depend on a number of factors and assumptions, and will require a degree of judgement.

The table below summarises the previous range provided by GAD and updates based on the advice below. To note, due to the inherent uncertainties in this analysis, the total ranges are not intended to be exactly equal to the sum of the components, therefore we have rounded to the nearest 0.25%:

Adjustment (% pa)	Tax on initial award size	Lifetime tax drag	Investment advice	Total reasonable adjustment	Narrower range
<b>Previous advice</b>	0.0% to 0.5%	0.0% to 0.5%	0.75% to 1.25%	0.75% to 1.50%	<b>0.75% to 1.00%</b>
<b>Changes</b>	Higher expected asset returns	Higher expected asset returns	Some indication of higher costs		
<b>Current advice</b>	0.5% to 1.5%	0.25% to 1.50%	0.75% to 1.75%	1.00% to 3.00%	<b>1.00% to 1.75%</b>

The current assumption was based on a range provided by GAD of 0.75% to 1.50% pa, which reflected a passive investment strategy. It was felt that an assumption towards the lower end of this range would be more appropriate. This was largely due to low assumed investment costs for passive investments and reflected that the taxable fund held by pursuers falls over the investment period, as set out below. This led to a recommended range of 0.75% to 1.00% pa, and the final choice of 0.75% pa from this range was a policy decision independent of GAD.

Since the assumption was set previously, the expected tax drag has increased. This is primarily due to higher expected returns on investments. Additionally, some evidence has been provided that indicates investment advice can be more costly in practice.

Considering the evidence below, a reasonable allowance for tax and investment costs might be in the region of 1.00% to 3.00% pa.

At the lower end this reflects a 0.25% pa increase, primarily due to assuming limited higher tax costs (for example, considering those with smaller claims or low other income). At the upper end this reflects a 1.5% pa increase reflecting both higher tax costs (for example, considering those



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with larger claims or a higher level of other income) and to reflect views around potentially higher investment costs faced in practice.

To note, the upper end of 3.00% pa is lower than the sum of the upper end of the lifetime tax drag and investment advice ranges of 1.50% and 1.75% pa respectively. This reflects our view that pursuers with higher tax drags, largely those with larger initial awards, are likely to have lower investment advice costs. Similarly pursuers with lower tax drags are likely to have higher investment advice costs. As a result, the upper end of the reasonable allowance does not include the scenario where pursuers have both a high lifetime tax drag and high investment advice costs, as this is viewed as outside of our reasonable expectations.

As before we believe that it is likely more appropriate to choose an allowance towards the lower end of this range, ie 1.00% to 1.75% pa, because:

- It is reasonable to assume that pursuers will take advice and shop around for competitive fees.
- This most closely reflects the level of expenses that we would expect for the investment portfolio assumed – namely passive returns from a static asset allocation and with an unchanging investment objective.
- The impact of tax illustrated above is based on the pursuer's tax position when they initially receive their award. As they make withdrawals from the fund, we would expect the pursuer's tax liability to reduce and so the tax obligation over the lifetime of the award will be lower than those shown above. Additionally, it is possible to reduce tax costs through efficient structuring of the portfolio.
- It is reasonable to assume that pursuers act as rational consumers and will compare charges and services provided by potential funds and, for two funds that provide the same service, choose the fund with the lowest fees, or only choose funds with higher fees if they provide additional value and/or returns.

Given the uncertainty around this estimate, GAD are unable to provide a view on the final assumption chosen based on the information we currently have available. However, we have noted that, in comparison to when the existing adjustments was set, changes in investment yields and tax rates have increased the tax burden on pursuers by around 0.5% pa on average (noting this is highly sensitive to the individual pursuer). Investment costs are largely unchanged but there are some indications of higher costs. As such, a 0.5% increase to the current standard adjustment for tax and investment costs would not be unreasonable in our view.

### **Interpretation of tax analysis**

It is inappropriate to use the analysis of tax on initial award size directly as an assumed level of annual tax burden, as it is intended to only reflect a single year of costs. To help with interpretation of our analysis, we have added the column on lifetime tax drag to the table above and you have asked us to illustrate potential outcomes for specific pursuers.

To note, this is just one way of interpreting the analysis, but may help you to consider what type of pursuer you are trying to represent and therefore what adjustment you should make. We only present the analysis you have directed us to undertake.

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Considering a pursuer who receives a 'medium' sized (£750k, as set out below) award. We consider it reasonable to assume that the 'average' outstanding award size over the lifetime would be between around half of the initial award size, as the fund size reduces over time and more of the fund can be moved to tax efficient arrangements.

- Under the previous analysis this would result in tax costs of around 0.2% pa.
- Under the current analysis this would result in tax costs of around 0.6% pa.
- Comparing these scenarios, suggests an increase to the adjustment by 0.5% pa would be reasonable.

If we instead consider a pursuer who receives a 'large' sized (£2m, as set out below) award:

- Under the previous analysis this would result in tax costs of around 0.4% pa.
- Under the current analysis this would result in tax costs of around 1.1% pa.
- Comparing these scenarios, suggests an increase to the adjustment by around 0.75% pa would be reasonable.

If we instead consider a pursuer who receives a 'large' sized award but with no other income:

- Under the previous analysis this would result in tax costs of around 0.1% pa.
- Under the current analysis this would result in tax costs of around 0.4% pa.
- Comparing these scenarios, suggests an increase to the adjustment by around 0.25% pa would be reasonable.

Considering the above, the bottom end of the range of 1.00% pa, reflects our view of the minimum reasonable adjustment in line with a low estimate of tax and investment costs. This could be indicative of investing in the cheapest investment funds and effectively utilising tax management options to reduce the tax drag over the award period for smaller claim size or where the pursuer has low levels of other income.

However, given the potential range of outcomes for pursuers and the uncertainty inherent in this analysis, it may be appropriate to select a higher assumption than this bottom end estimate. As the bottom of the range may not cover tax costs for a sufficiently broad range of pursuers (as set out in the example above) an assumption of 1.25% pa would likely be required to cover the higher tax costs of those with medium claim sizes and the assumed level of other income. Alternatively, the top end of the narrower range of 1.75%, reflects our view of a reasonable adjustment in line with considering those with a larger claim (and hence higher tax burdens) or an allowance for investment costs at the higher end of the range for largely passively managed funds.

If time and budget permits we would be pleased to consider what further research could support a better informed view of an appropriate assumption to use, although there will never be a perfect assumption given the unknown nature of future claims and variation in individual pursuer circumstances.

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Further, although we believe that a deduction towards the lower end of the range is likely to be appropriate, an adjustment above 1.75% could be plausibly justified. In particular, an adjustment towards the higher end of this range might be appropriate if:

- Pursuers are assumed to be compensated for investing in a wider range of funds – for example through an investment adviser, via investment platforms and/or in active funds – and the additional expected excess returns that such strategies are expected to deliver are ignored.
- We focus on pursuers with ‘smaller’ sized funds that are likely to incur larger fees, or ‘larger’ sized funds that are likely to incur larger tax charges.
- Pursuers are assumed to have large claims as well as other sources of income which are likely to lead to higher tax charges.
- We take an approach that ensures the deduction is large enough to account for the costs of most pursuers.

Our sensitivity analysis also shows that it is possible the increase in tax costs could be lower for certain pursuers, in particular for those with no other income. If there was evidence to suggest that these pursuers represent a significant proportion of the pursuer population, then it may be appropriate to assume a deduction below the range presented.

## Taxation

The appropriate allowance for tax will be unique to each pursuer and will depend critically upon both:

- **individual circumstances** – such as the claim amount, how this is invested, the interest and dividends earned on those investments and other sources of income<sup>8</sup>; and
- **the tax structure that is in force at the time** – in terms of tax free allowances, tax thresholds, and marginal tax rates.

Even for an individual pursuer, the appropriate allowance for tax is unlikely to remain constant over the expected period of their damages because:

- **The size of the pursuer’s fund will reduce as they make withdrawals from the fund** – reducing the pursuer’s earned income and hence tax liability, and allowing a larger proportion of assets to be held in tax-free or reduced tax arrangements such as ISAs.
- **The pursuer’s circumstances may change** – for example their other sources of income may change as a result of retirement or a change in job.
- **Investment conditions can change** – for example higher interest rate environments may result in higher income from the fund.

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<sup>8</sup> While the legislation sets out that the hypothetical investor has no financial resources to meet the losses they are being compensated for other than their damages, this does not mean they do not have other income which they rely on to fund costs that are unrelated to their damages.

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- **Tax regimes may change.**

## **Responses to the 2018 Call for Evidence**

Many respondents to the 2018 Call for Evidence were of the view that, overall, tax effects are negligible, but that they can vary considerably by individual circumstances and are difficult to generalise. Other points raised by respondents with respect to tax were:

- Larger rewards result in more investment income and hence are more liable to tax.
- Lump sums reduce over lifetime and hence tax effects will reduce.
- Tax planning comes after investment strategy advice, which should be the main focus.

## **Responses to the 2023 joint request for views**

The responses to the 2023 joint request for views were very similar to those received in 2018. However it was noted by respondents that the higher returns available on assets currently would suggest higher tax costs for pursuers.

## **Analysis**

In the 2018 Scotland report and the 2019 advice to the Lord Chancellor the impact of tax was illustrated through some high-level analysis of the current tax system in place. This showed a reasonable range for the tax drag on investment returns over a single year of 0.1% to 0.5% pa in Scotland and 0.0% to 0.5% pa in England and Wales.

These reports highlighted that in a higher interest environment these results would no longer be appropriate. Additionally, many tax allowances and brackets have lowered relative to inflation since this previous analysis. Therefore we have updated the analysis to illustrate a reasonable range of the impact of taxation under expected assumptions as at the 2024/25 tax year. This includes announced future changes to tax rates and allowances but does not assume any further changes. For details on the underlying economic assumptions see Annex B. To note, these economic assumptions are in line with views as at 30 September 2023.

The key assumptions and variables considered in this analysis are:

- Whether pursuers have other taxable income – which will reduce the level of income tax allowance that can be used on investment income. As set out above, this does not contradict the definition of the hypothetical investor, as this income is assumed to not be available to fund their damages.
- What investment strategy pursuers adopt – as different assets attract different tax treatment.
- The taxable returns from investments due to savings income and dividends.
- How pursuers are assumed to invest, and in particular, how this might crystallise capital gains liable for capital gains tax.

		Central analysis		
		A	B	C
<b>Description</b>		Small claim	Medium claim	Large claim
<b>Award size (£)</b>		100k	750k	2m
<b>Other income (£ pa)</b>		25k	25k	25k
<b>Investment Strategy / Assumed income yield</b>	<b>Cash</b>	10% / 4.0% pa		
	<b>Bonds</b>	60% / 4.5% pa		
	<b>Equity</b>	30% / 3.5% pa		
<b>Tax drag on fund in first year</b>		<b>0.5%</b>	<b>1.0%</b>	<b>1.5%</b>

Note: we include an approximate allowance for capital gains tax on equities, by assuming a proportion of the portfolio is sold and subject to capital gains tax on assumed capital growth.

We have consulted with HMRC who have provided assurance on the appropriateness of the calculations performed.

Based on the above, and under the current tax system and current economic conditions, an adjustment for tax in a single (first) year of 0.5% to 1.5% might be reasonable.

However, different adjustments for tax may be justifiable. For example, if we were to return to an economic environment similar to 2018, we would again see the lower tax drags, although this would be partially offset by the changes in tax bands since that time. The table below sets out sensitivity analysis demonstrating that in an economic environment with lower yields, in line with the 2018 Scotland report, the tax drag would be lower. However, the upper end of the range has increased from 0.6% to 0.7% due to changes in tax bands.

		Lower yield sensitivity		
		A	B	C
<b>Description</b>		Small claim	Medium claim	Large claim
<b>Award size (£)</b>		100k	750k	2m
<b>Other income (£ pa)</b>		25k	25k	25k
<b>Investment Strategy / Assumed income yield</b>	<b>Cash</b>	10% / 1% pa		
	<b>Bonds</b>	60% / 2% pa		
	<b>Equity</b>	30% / 3.5% pa		
<b>Tax drag on fund in first year</b>		<b>0.1%</b>	<b>0.3%</b>	<b>0.7%</b>

This shows the analysis is sensitive to the assumed investment return on assets. To demonstrate this further we have produced the sensitivity analysis below which sets out outcomes assuming 1% higher returns for each asset. For equities we have assumed a 0.5% higher dividend yield and a 0.5% higher capital gain. As the table shows, the higher the assumed return the higher the tax drag, with the increase being greater the larger the award. This mirrors the lower yield sensitivity analysis above.

		Higher yield sensitivity		
		A	B	C
<b>Description</b>		Small claim	Medium claim	Large claim
<b>Award size (£)</b>		100k	750k	2m
<b>Other income (£ pa)</b>		25k	25k	25k
<b>Investment Strategy / Assumed income yield</b>	<b>Cash</b>	10% / 5.0% pa		
	<b>Bonds</b>	60% / 5.5% pa		
	<b>Equity</b>	30% / 4.0% pa		
<b>Tax drag on fund in first year</b>		<b>0.6%</b>	<b>1.3%</b>	<b>1.9%</b>

In line with the previous analysis, we have assumed that pursuers have other income. This is now a more material assumption due to the larger impact of tax on pursuer returns. Therefore, we also present sensitivity analysis demonstrating the impact of other income on the medium pursuer.

		Other income sensitivity		
		A	B	C
<b>Description</b>		Medium claim, no other income	Medium claim, some other income	Medium claim
<b>Award size (£)</b>		750k	750k	750k
<b>Other income (£ pa)</b>		0	10	25
<b>Tax drag on fund in first year</b>		<b>0.2%</b>	<b>0.5%</b>	<b>1.0%</b>

We can see that assuming no other income reduces the calculated tax drag significantly. This is because pursuers with less other income benefit from greater tax relief on investment returns and therefore pay no tax on a larger proportion of their investment income.

It is also important to note that we expect that the larger the claim, the less likely pursuers are to have another source of income. This is because large claims typically result from more serious injuries which will limit the ability for the pursuer to find employment.

## Choice

It is inappropriate to use this tax analysis directly as an assumed level of annual tax burden, as it is intended to only reflect a single year of costs. The tax drags illustrated above will reduce over time as the size of the pursuer's fund reduces, due to withdrawals from the fund and a larger proportion of the fund falling under tax free allowances.

In light of this, and the responses to the Calls for Evidence, an appropriate overall range for lifetime tax costs could be 0.25% to 1.5% pa. However, it is reasonable to narrow this range further to reflect that, on average over a lifetime, pursuers are not expected to experience the highest tax burden calculated. Taking the lower end gives a reasonable range of 0.25% to 0.75% pa.

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It should be also noted that the impact of tax on some individuals may be higher (eg higher rate taxpayers still in employment, who use up tax-free allowances in earnings), however for the purposes of this analysis, we have not made any adjustments in respect of this type of possible pursuer.

## Investment advice and management

The level of fees and expenses incurred by pursuers will depend critically on the pursuer's settlement, fund choice and investments approach. In particular:

- Larger funds typically pay lower fees (when expressed as a percentage of the fund size).
- Investment in passive funds, which track a particular index, will typically attract lower charges than active funds.
- Some funds charge entry fees, though many don't.
- Some funds charge performance fees.
- Investments in different asset classes will attract different charges – for example investment in 'alternative' illiquid investments will typically attract higher charges than liquid frequently traded investments.
- Different investment approaches will attract additional charges – for example some investment platforms also include custodian and other administrative functions.

As a result, expenses incurred by pursuers will reflect their individual circumstances and preferences, and the analysis presented here is only an illustration.

At a high level, expenses incurred by investors could be broken down into the following types:

- **Fund management fees** – charged by the fund that the investor invests in, they contribute towards the fund manager's profits, whilst covering their costs such as researching and selecting investments for the fund.
- **Custodian/platform fees** – payable to the platform that administers the investments.
- **Trading costs** – these are the costs relating to buying/selling the underlying securities, for example bid/offer spreads, commission, dealing costs.
- **Adviser fees** – fees charged by Independent Financial Advisers for any advice provided on what investments/funds the investor should invest in.

As set out in the 2018 Scotland report, the cost of investment advice and management was analysed in two ways. Firstly, it examined the fund management fees for the 20 sample funds used to derive the notional portfolio. This found that most funds had fees in the range of 0.2% to 1.5% pa. Secondly, it referred to the Money Advice service, which showed that tracker funds typically had fees of 0.25% to 0.85% pa. Overall, this led to a reasonable range of 0.25% to 1.00% pa for a pursuer with a large fund.

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Updating the analysis of the 20 sample funds for the 18 funds analysed in the notional portfolio chapter and we find a similar range, from 0.2% to 1.8% pa.

After the 2018 Scotland report, further work was done to understand the appropriate adjustment for tax and investment advice, focusing on the investment fees. The key source of further information was the 2018 Call for Evidence which was also used to inform the 2019 advice to the Lord Chancellor.

The consideration of investment fees in the 2018 Call for Evidence was separated into adviser fees, fund management fees, and platform fees (including trading costs). It found that due to the different types of fees, even under a passive approach the total cost can be higher than the low fund management fees discussed above. This analysis is summarised below, with an adjustment to the fund manager fee to reflect analysis specific to the notional portfolio:

Sector	Ongoing Charge pa	Notes
Adviser fee	0.25% to 0.5%	Part Active <sup>9</sup>
Fund manager fee	0.4% to 0.6%	Passive
Platform fee	0.1% to 0.2%	Passive

The above gives a rounded reasonable range for total investment advice costs of 0.75% to 1.25% pa.

In the 2023 joint request for views respondents from the pursuer's perspective argue that these assumptions are too low, with data showing an average total fee of around 1.5% pa. We have not seen all of the detailed data underlying this, however we understand this aligns with evidence submitted in 2019, showing similar average fees. In 2019 some detailed data was provided by a pursuer solicitor group, which showed weighted average fees of 1.6% across 389 clients and 9 firms, with a range of charges from 0.6% to 3.3%.

The level of expenses is largely driven by the investment approach, as broadly speaking, more active or engaged investment approaches lead to higher expenses. However, these higher costs should be cancelled out by even higher returns. This means it is expected and reasonable that the fees in the table above align with the bottom end of the range shown in the evidence supplied.

In line with previous reports, it is important to maintain consistency between the assumed investment costs, and the composition and return projections of the notional portfolio. It is therefore appropriate to assume low investment costs, in line with passive returns from a static asset allocation and an unchanging investment objective. Therefore assuming an active approach would likely influence the Government Actuary's determination of the return achieved on the portfolio, reflecting higher returns in exchange for higher fees.

Overall, based on the evidence we have seen we do not think it is appropriate to change the lower end of the overall reasonable range for investment advice costs. However, in light of the responses to the joint request for views, we do think it is reasonable to reflect the potential for higher costs at the upper end of the range. Therefore we advise that a reasonable range based on current evidence would be 0.75% to 1.75% pa.

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<sup>9</sup> Reflecting the need for initial investment advice based on an assessment of the pursuer's objectives and risk profile, and monitoring of the passive portfolio.



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## 6. Margin

**Do the standard adjustments provided in paragraph 10 (0.75% for the impact of taxation and the costs of investment advice and management; and 0.5% as the further margin) remain appropriate?**

To provide further protection to pursuers, the margin is applied to reduce the likelihood of pursuers being undercompensated. The current margin is 0.5% pa.

Without a margin for prudence, if all the underlying assumptions and projections match experience, then 50% of pursuers are expected to be undercompensated and 50% overcompensated, due to investment risk. This is based on projected investment returns across the notional portfolio in comparison to damages inflation. By adding a margin for prudence this can be adjusted, reducing the likelihood of under-compensation.

The exact impact of a margin for prudence depends on the spread of outcomes for pursuers. If all pursuers were expected to experience very similar outcomes, then a very small change in the margin could result in very few pursuers being undercompensated.

The spread of outcomes depends on the underlying analysis methodology, including the notional portfolio and investment period discussed above, as well as the economic projections used. This means the exact impact of the margin for prudence cannot be known until the full rate review is carried out by the Government Actuary.

Given that we cannot calculate the exact impact of the margin, we have not undertaken any additional analysis. However, we previously developed rules of thumb that have been verified to be reasonable across a range of economic conditions, notional portfolios and investment periods. These rules of thumb therefore provide GAD's estimate of the impact of retaining the current 0.5% margin, and this is in line with the advice provided to inform your previous review, as set out below:

- A margin of 0.25% results in broadly a 40% chance of under-compensation
- A margin of 0.5% results in broadly a 30-35% chance of under-compensation
- A margin of 0.75% results in broadly a 20-30% chance of under-compensation

This implies that a margin of 0.5% remains suitable unless:

- Your preferred level of prudence has changed.
- Other aspects of the methodology have changed or been reconsidered which necessitate adjustments to the margin. In particular, the probabilities above only reflect investment risk movements from a 50% chance of under-compensation. The probabilities therefore do not capture other risks pursuers are exposed to, such as longevity or needs risk, or any deviation from a best estimate basis for the other assumptions considered. We understand that it is not possible under the legislation to make any adjustments for this, therefore we have not considered these points further in our advice.

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## 7. Dual or multiple rates

**Does current available evidence suggest that Scottish Ministers should consider making regulations under paragraph 21 to require that more than one rate of return should be set and, if so, to what circumstances should these rates relate?**

Currently a single PI discount rate is used to calculate pursuer awards. Alternatively, legislation allows for multiple rates to be used to apply to different parts of the settlement.

It may not be appropriate to make regulations requiring more than one rate of return. This is in line with the views of the majority of both pursuers and defenders who responded to your joint request for views. In particular respondents highlighted that:

- To prepare internal systems and the necessary analysis, a long transition period may be required before multiple discount rates could be implemented. There would also be implementation costs for courts, insurers, pursuer representatives and government.
- Multiple discount rates could result in increased costs and time taken during court cases. This is because there would be additional items to negotiate over, and analysis of the damages would be more complex.
- The increased complexity could also have a negative effect on pursuers, as they may be less able to understand the system. This could also affect the level of trust in the discount rate and personal injury regime overall.

If you were to implement a multiple rate system, additional actuarial analysis would be required to inform the appropriate methodology and assumptions.

For a rate split by heads of loss, it would be necessary to identify appropriate inflation assumptions for different heads of loss. This may be difficult due to the number of heads of loss that constitute pursuer's damages, lack of data covering all of these heads of loss, and the availability of inflation measures to accurately capture the inflation those heads of loss experience. However, this approach could reduce issues around the suitability of a single damages inflation assumption.

Additionally, if the rate was split by heads of loss, this would require an assessment of the appropriate assumptions to apply to the specific heads of loss beyond damages inflation. In particular, different heads of loss may have different expected durations, and this will impact the investment period and strategy. We think the case is strongest here when considering damages providing payment for lost earnings, as these would end at an assumed retirement age, while most other costs are likely to continue until death. Due to the shorter investment horizon, this could suggest a lower risk notional portfolio.

For a rate split by award term, it would be important to determine at what point(s) the rates changed, how the rates were applied to awards and appropriate assumptions to apply for each duration. As above this would impact the investment period and strategy.

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Whichever decision is made, we recommend exploring this topic further, in particular continuing to engage with stakeholders to understand their preferences and better understand the practical implications of the change.

## Background

Under previous PI discount rate regimes and the current methodology, a single discount rate is used. This is a simple methodology making it easier to understand and practical to implement. However, this is a simplification that limits the range of pursuer outcomes that can be considered. Two key impacts of this simplification are:

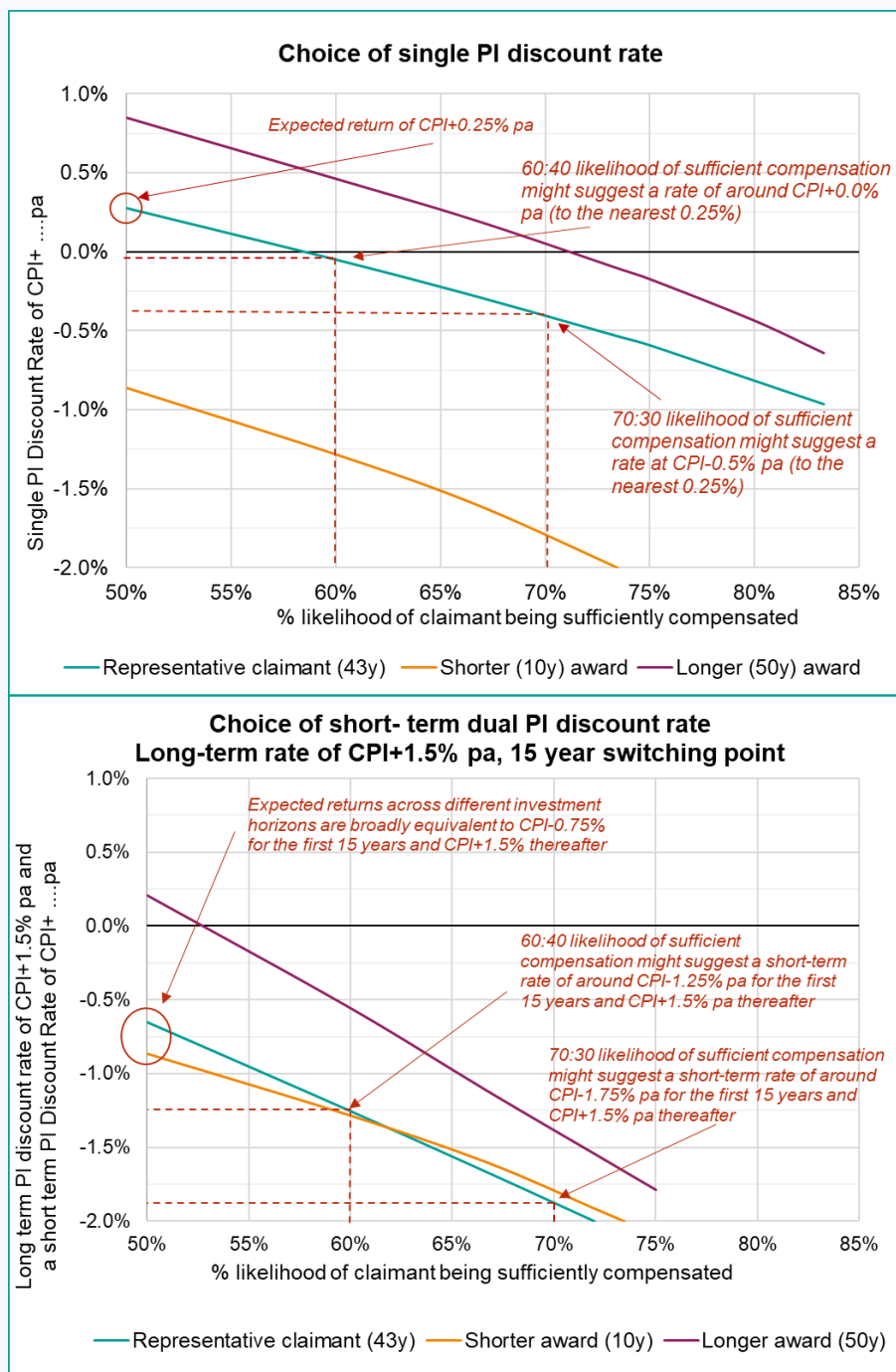
- **Different outcomes for different terms of award** – As the discount rate is currently based on a fixed investment period, the outcomes for pursuers with a shorter or longer term may not be the same. This can mean that on average these pursuers are over- or undercompensated more than expected.
- **Different mix of damages** – As the discount rate is currently the same for all heads of loss paid to pursuers, the outcomes for pursuers with damages that inflate at a rate higher or lower than the assumed inflationary measure may not be the same. This can mean that on average these pursuers are over- or undercompensated more than expected.

## England and Wales

Outcomes under a dual rate approach split by duration were shown in the 2019 advice to the Lord Chancellor (see pages 6 to 8). This analysis showed that under a dual rate, outcomes for pursuers with different awards lengths could be made more consistent.

The graphs in Figure 5 below demonstrate this, by showing that the pursuer outcomes under different award lengths (as represented by the different coloured lines) are closer under a dual rate compared to a single rate approach.

Figure 5: Likelihood of sufficient compensation under different discount rates by duration of award, single discount rate compared to dual



Ultimately the Lord Chancellor decided that it was not the correct time to implement a dual rate, due to a lack of quantity and depth of evidence. This led to the Call for Evidence discussed below.

## Joint request for views

The 2023 joint request for views gathered opinions on implementing a dual or multi rate approach. In this pursuer representatives broadly support a rate split by heads of loss, while defender

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representatives were more supportive of a rate split by term. The majority of respondents agreed that more evidence should be gathered before adopting a dual rate, and a transition period will be required to allow for practical implementation.

## **2023 Call for Evidence**

The England and Wales rate review is required to start before mid 2024, and this could result in a dual or multi rate. The 2023 Call for Evidence focused on views around a dual or multi rate approach, specifically for England and Wales. Many respondents to the 2023 joint request for views referred to their response to this Call. Based on the government response to the 2023 Call for Evidence, the views provided align with those in the joint request for views as set out above.

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# Annex A: Referenced material

## Reports and analysis referenced:

- [2018 Scotland report](#) – GAD report advising on the notional portfolio, margin for prudence and allowance for expenses and tax, dated 5 September 2018.
- [2019 advice to the Lord Chancellor](#) – Government Actuary’s report to support the Lord Chancellors determination of the PI discount rate, dated 25 June 2019.
- [2020 Northern Ireland memo](#) – GAD memo considering whether the notional portfolio in use by Scotland was still appropriate and whether a 30 year investment period was still appropriate, dated 20 November 2020.

## Stakeholder evidence collections referenced:

- [2018 Call for Evidence](#) – Call from the Ministry of Justice concerning the assumptions to set the PI discount rate in England and Wales.
- [2023 Call for Evidence](#) – Call from the Ministry of Justice concerning the use of a dual or multi discount rate in England and Wales.
- [2023 joint request for views](#) – Request for views jointly issued by the devolved administrations of Scotland and Northern Ireland, covering the methodology discussed in this paper. The response to this request has not been published yet. We have relied on the responses shared with us by Scotland and Northern Ireland, our characterisations do not represent a formal summary of responses.

# Annex B: Tax drag calculation assumptions

Item	2018 assumption	2023 assumption	Rationale
<b>Cash Interest</b>	1.0% pa	4.0% pa	The Bank of England base rate was 0.75% when the 2018 assumption was in force. The base rate was 3.5% at the start of 2023 and was 5.25% as at September 2023, we have taken an assumption at the lower end of this range.
<b>Bond Interest</b>	2.0% pa	4.5% pa	Looking at the nominal 20-year spot yield on government bonds shows an average of ~2% pa in the period leading up to the 2018 report. Since then yields have increased significantly, sitting at ~4.5% pa as at September 2023. Corporate bond yields are higher than those for government bonds but reflecting this is unlikely to have a material impact on the tax analysis.
<b>Equity Dividend yield</b>	3.5% pa	3.5% pa	Dividend yields looking at both UK and international equities show a consistent yield of ~3.5% pa in both 2018 and as at September 2023.
<b>Equity Capital growth</b>	2.0% pa	3.0% pa	We estimated capital growth based on total equity returns netting off the dividend assumptions above. The GAD internal equity return assumption was ~5.5% pa in 2018, this has now risen to ~6.5% pa as at September 2023.
<b>Equity Churn</b>	10.0% pa	10.0% pa	Looking at large passive funds we see very low churn of ~5% to ~15%. We would not expect this to change over time.

# Annex C: Commissioning letter

The commissioning letter received from the Scottish Government is reproduced below.

Justice Directorate  
Civil Law and Legal System Division



E: [michael.paparakis@gov.scot](mailto:michael.paparakis@gov.scot)

Steve Humphrey  
Government Actuary Department

By email to  
[stephen.humphrey@gad.gov.uk](mailto:stephen.humphrey@gad.gov.uk)

16 June 2023

Dear Steve

## Review of personal injury discount rate for Scotland

As you know, under paragraph 2 of Schedule B1 to the Damages Act 1996, the Government Actuary must begin a review of the personal injury discount rate for Scotland on 1 July 2024. Paragraph 16 of that Schedule requires Scottish Ministers, before such a review, to consider whether regulations are necessary for ensuring that the notional portfolio remains suitable for investment in by a hypothetical investor, and to consult such persons as we consider appropriate. Scottish Ministers also have powers to make regulations to amend other features of the rate-setting methodology as prescribed in the Schedule. Any regulations would require affirmative resolution of the Scottish Parliament before July 2024. If we are to make regulations before then, we need to allow sufficient time for stakeholder engagement, receipt of professional advice, consideration of that advice, the drafting of regulations, and Scottish Parliamentary procedures.

This letter, therefore, is to commission – in order to inform our consideration of the need for regulations – advice from the Government Actuary's Department on the following, considering additional, readily available evidence since you last advised.

1. Does the notional portfolio as provided in paragraph 12 of Schedule B1 remain suitable for investment in by a hypothetical investor as described in paragraph 17?

St Andrew's House, Regent Road, Edinburgh EH1 3DG  
[www.gov.scot](http://www.gov.scot)





2. Does the assumed period of investment of 30 years, as provided in paragraph 7, remain appropriate?
3. Does RPI remain the most suitable reference for allowing for the impact of inflation under paragraph 9 and, if not, is there alternative 'published information relating to costs, earnings or other monetary factors' that we could prescribe in regulations under paragraph 9(2)(b)?
4. Do the standard adjustments provided in paragraph 10 (0.75% for the impact of taxation and the costs of investment advice and management; and 0.5% as the further margin) remain appropriate?
5. Does current available evidence suggest that Scottish Ministers should consider making regulations under paragraph 21 to require that more than one rate of return should be set and, if so, to what circumstances should these rates relate?

We have written to stakeholders on 31 May, seeking their views on the above, and any evidence to support their views, by 11 July. We will forward any responses to you after this date so that they can inform your advice.

You will also be aware that the Ministry of Justice intends to publish a response document in July to its call for evidence on options for dual or multiple discount rates for England and Wales. We would be grateful if you could also consider this when advising on point 5.

We have been liaising with colleagues in Northern Ireland's Department of Justice, and understand that they will be writing to you in similar terms, seeking the same advice in relation to the discount rate for Northern Ireland.

We would be most grateful for receipt of your advice by 30 September.

For ease of reference, I have attached a copy of Schedule B1 to my covering email.

Kind regards,

Michael Paparakis  
Policy Manager,  
Private Law Unit

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