

21 July 2010

Mark Hoban MP
Financial Secretary to the Treasury
Her Majesty's Treasury
1 Horse Guards Road
London
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Dear Mr Hoban

Sir John Chadwick's advice in relation to the Equitable Life Payment Scheme

Following the submission of Sir John Chadwick's report "Advice to Government in relation to the proposed Equitable Life payment scheme" dated 16 July 2010 ("Sir John's Advice"), you have asked that we set out a summary of the calculation of losses that follow from his Advice and a provisional estimate of the amount that would be paid to policyholders if an Equitable Life payment scheme ("ELPS") were implemented on the basis of his Advice. You have also asked that we provide estimates of the results of certain intermediate calculations that help to explain the derivation of the final loss estimate and a description of the approach used to produce the estimate. This letter responds to this request. It should be read in conjunction with Sir John's Advice.

Background

In January 2009 Sir John was appointed to provide advice to the Government in relation to its proposal to establish a fair ex gratia payment scheme in response to the Report of the Parliamentary Ombudsman on her investigation into the prudential regulation of Equitable Life. We have produced a document addressed to Sir John which provides the specific advice which he requested, "Equitable Life Payment Scheme, Advice to Government, Actuarial Advice to Sir John Chadwick" dated 14 July 2010 ("the TW Advice"). Separately, based on the database of policyholder records provided by Equitable Life, we have been asked by the Treasury to provide estimates of a range of loss figures, including the amount that would be paid to policyholders pursuant to a payment scheme based, as closely as possible, on Sir John's Advice together with other assumptions as necessary.

Methodology

In his Advice, Sir John has, in response to his revised terms of reference, advised as to:

"The extent of relative losses suffered by different classes of policyholder in respect of each case of maladministration, taking account of, among other things, wider market conditions during the period under consideration, and comparable insurance products available over the same period; [and]

The proportion of those losses which it would be appropriate to apportion to the public bodies investigated by the Ombudsman, as opposed to the actions of Equitable Life and other parties."

At paragraph 6.3 of his Advice, Sir John summarised the method for calculating relative loss ("the five step process"). The process is as follows:

"[An] appropriate method of assessing individual loss resulting from accepted maladministration is by five steps:

(i) First, to assess External Relative Loss – which is "relative loss" in the sense which I understand the Ombudsman intended, that is to say, "financial loss suffered by a policyholder from his investment in Equitable Life which would not have been suffered if the policyholder had made the same investment with a comparable with-profits fund" – in relation to all new investment between 1 September 1992 and 31 December 2000.

(ii) Second, to treat each policyholder or former policyholder as having suffered a proportion of the External Relative Loss assessed in respect of the new investment which he made during that period: such proportion to be determined by reference to an estimate of the extent by which the aggregate of new investment in the Society (in respect of policies of the relevant class) would have reduced if the maladministration accepted by the Government had not occurred.

(iii) Third, to assess what I shall describe as the "Internal Relative Loss" suffered by each policyholder (including those who made no new investment between 1 September 1992 and 31 December 2000) in respect of the whole of his investment in Equitable Life with-profits policies (whenever made). Internal Relative Loss is the difference between:

(a) what the policyholder would have received (or would in the future receive) in respect of his investment in Equitable Life with-profits policies if, in the regulation of the Society, the maladministration which the Government accepted had not occurred; and

(b) what the policyholder has received (or will in the future receive) in respect of his investment in Equitable Life with-profits policies in the events which happened.

(iv) Fourth, to treat each policyholder or former policyholder as having suffered a proportion of the Internal Relative Loss; such proportion to be the complement of the proportion applicable to his External Relative Loss.

(v) Fifth, to treat each policyholder as having suffered an amount of individual loss equal to the aggregate of his proportions of External Relative Loss and Internal Relative Loss.."

This process is critically dependent on the assumption that Equitable Life would not have closed to new business prior to the end of 2000 and material volumes of new business would have been written during the 1990s, absent accepted maladministration. If that assumption is not made, steps three, four and five of the five step process can not apply.

- Sir John summarised the method for calculating "External Relative Loss" as the two-stage process (to which sub-paragraph (i) above referred) at paragraph 4.46 of his Advice:

"(i) First, it is necessary to determine the difference between:

(a) payout (allowing for any guarantees in the policy terms) that would have been received (or would in the future be received) by the policyholder in respect of the relevant Equitable Life policy if the final policy value cuts of 2001 and WPA (with-profit annuity) cuts in 2003 had not occurred; and

(b) the payout which has actually been received (or which will in the future be received) in respect of that Equitable Life policy.

(ii) Second, it is necessary to determine the difference between:

(a) the payout which would have been received (or would in the future be received) in respect of a comparable product offered by an alternative provider; and, again

(b) the payout which has actually been received (or which will in the future be received) in respect of the relevant Equitable Life policy.

External Relative Loss would be determined as the lower of (i) and (ii). Where (ii) is greater than (i), "absolute loss" – measured by (i) – imposes a cap".

- In Part 7 of his Advice, Sir John has set out his reasons for concluding that there would have been some reduction in premiums received by Equitable Life over the period, if the accepted maladministration had not occurred. Sir John has advised that in his view this reduction would have been between one sixth and one quarter (at paragraph 7.76). In accordance with this, he advised (in paragraph 7.77) that the proportion to be applied to External Relative Loss should be 25% in respect of with-profit annuity policies and 20% in respect of all other policies.

Sir John has advised that the loss should be calculated: at the date of calculation, where policies are still in-force, or, where the policy has terminated earlier, at the date of termination. He has advised that it would be appropriate to add interest to the payments in respect of the period between the date as at which loss is calculated and the date of payment. Neither Sir John's Advice nor the TW Advice includes advice on a suitable level of interest, as this is a matter for the Government to decide. However we have set out in the assumptions below the interest rate which has been applied in the calculations which form the basis of the estimate set out in this letter.

In this letter we have followed the approach outlined by Sir John, summarised above, where possible. However, in a number of areas we have had to make additional or alternative assumptions in order to estimate, at this stage, the total aggregate relative loss. Some of these additional or alternative assumptions are summarised under the additional areas of uncertainty. There are a number of reasons why some of these assumptions may change:

- There are some assumptions where we have had to make approximations or simplifications at this stage, rather than to follow exactly Sir John's Advice;
- There are a number of assumptions which were not part of Sir John's remit, which we have made in order to estimate the losses, and will ultimately be for the Government to decide; and
- We have also made a number of technical assumptions, which may be subject to change.

To the extent that the assumptions change, the figures will change.

Technical issues

The approach set out in Sir John's Advice (and which is based on that identified originally by the Parliamentary Ombudsman) requires a number of technical issues to be addressed. These issues have been described in further detail in the TW Advice.

External Comparators

Choosing an appropriate comparator

In order to compare the performance of Equitable Life policies with those of other product providers, a comparable product needs to be identified. Given the flexibility of the Equitable Life product range, some comparator companies do not have directly comparable products, particularly in the case of with-profit annuity policies. Whilst other providers may have suitable products for part of the period in question, they may not have been available for the whole of the period.

Identifying comparator performance

A further complexity arises in respect of the application of bonuses. Whilst bonus rates are generally available for calendar years, they may vary according to type of contract, generation of contract, duration in-force and size of premiums. The level of bonuses paid on termination before the original contract term will also vary from company to company and from time-to-time.

Allowing for variation in policyholder behaviour

The treatment of partial surrenders, variations in premium levels including suspension of premium payments and ceasing further premium payments will also vary according to different companies.

Approach to addressing comparator issues

Given the complexities highlighted above and the significant variation in the charging structures applied by the different companies, it is not practical to identify for each of the approximately 1.5m Equitable Life policies the payouts of equivalent policies with a number of different comparators. Instead, it has been necessary to develop an approximation based on public data and the information we have available to us in respect of the Equitable Life policies. The approach we have adopted is described in Section 7 of the TW Advice.

External Relative Loss calculation

A number of approximations and assumptions (in addition to those set out in Sir John's Advice and the TW Advice) have been made to estimate the External Relative Loss at this stage. We do not believe that the impact of most of these assumptions or approximations will have a material impact on the estimates set out in this letter.

We have made some approximations in order to estimate the External Relative Loss allowing for the Absolute Loss. As this is reflected more accurately in the calculations, this may materially affect the loss figure.

Deriving the bonus rates for the calculation of internal relative loss

In his revised Terms of Reference, Sir John's advice was sought as to the extent to which the information shown in Equitable Life's regulatory returns would have differed if the maladministration which the Government accepted had not occurred. In order to respond to that request, the regulatory returns of Equitable Life for the period covered by the Ombudsman's investigation were reconstructed, as described in Part 3 of Sir John's Advice, and in Sections 4 and 6 of the TW Advice. Equitable Life as it would have been (absent maladministration), as reflected in the reconstructed regulatory returns, has been defined as "the Reconstructed Equitable Life". The bonus rates of the Reconstructed Equitable Life and the corresponding policy value cuts were derived from the new business reduction which Sir John describes in Part 7 of his Advice and is used to calculate the Internal Relative Loss. Again this approach is critically dependent upon the assumption that Equitable Life would not have closed to new business prior to the end of 2000, and would have continued to write material volumes of new business, absent accepted maladministration. If this is not accepted, the bonus rates, policy value cuts and consequential losses have no basis, given their derivation from the returns reconstructed on these assumptions.

Data issues

Range of policy options

Equitable Life sold a number of different types of policies which are described in more detail in Appendix B of the TW Advice. The aggregate relative loss is derived from policy (or policyholder) losses and the workings of all of the different policy types are required in order to calculate the losses.

We have identified, and Sir John has noted in his Advice, particular difficulties in assessing loss for conventional with-profits policies.

Missing data

The information provided by Equitable Life as to the policies in-force in the relevant period is incomplete. This is described in Section 3 and Appendix B of the TW Advice. We have therefore had to reconstruct certain elements of the data either using the characteristics of the policy information that is available, or, where a more accurate approach is not available, using approximations. These approximations will, where appropriate, need to be refined in determining the final loss figures.

Taxation

Treatment under assessment of relative loss

The assumption as to what allowance for tax should be made in the assessment of loss is complex. We have highlighted this in the TW Advice, where we summarise the tax treatment of different policy types.

Treatment of payments

Sir John has not advised on the treatment of taxation of payments under the ELPS (he was not asked to do so). The treatment of the taxation of any payments to be made is complex and it will be difficult to achieve equity between different types of policyholders. In practice the impact of taxation depends not only on the type of policy but also on the tax status of the policyholder.

Estimates

Bases of calculation

We have set out, as requested, the intermediate steps required to calculate the loss based on the five step process which Sir John identified, (at paragraph 6.3). In Table 1 we have shown the aggregation of the calculations for each policy across the entire population. This aggregation is not part of Sir John's Advice, but an approach you have asked us to adopt to illustrate how the loss figures are constructed. Also in the context of Sir John's Advice, the figures shown, by rows 1, 2 and 3 without the factors identified (under 4) and applied in row 4 have no meaning. In the context of his Advice, these are steps to illustrate the process of the calculation, not loss figures themselves.

1. Aggregated Absolute Loss ("Absolute Loss") -
 - Absolute Loss, as defined by the Ombudsman and explained by Sir John in Part 4 of his Advice, is derived as the difference between the payout (allowing for the guarantees in the policy terms) that would have been received (or would have been received in the future) by the policyholder in respect of the relevant Equitable Life policy if the final policy value cuts of 2001 and with-profit annuity cuts in 2003 had not occurred and the payout which has actually been received (or will be received in the future), in respect of the Equitable Life policy. This represents the first stage of the two-stage process, required to assess the External Relative Loss, which Sir John has identified in Part 4 of his Advice (at paragraph 4.46). This estimate is based on the premiums paid from 1 September 1992 (where they are known) to 31 December 2000;
2. Aggregated Stage 2 Loss ("Aggregated Stage 2 Loss") -
 - Stage 2 Loss is the difference between the payout which would have been received (or would have been received in the future) in respect of a comparable product offered by an alternative

provider and the payout which has actually been received (or will be received in the future), in respect of the Equitable Life policy. This represents the second of the two-stage process, required to assess External Relative Loss, which Sir John has identified in Part 4 of his Advice (at paragraph 4.46). The comparable products offered by the alternative providers are represented by the comparator companies identified in Part 4 of Sir John's Advice (at paragraphs 4.85 to 4.90), and in Section 5 of the TW Advice. The main criterion used to select the comparator companies was the volume of new business sold, as described in Section 5 of the TW Advice. These comparators are generally the better performing companies over the period. These estimates have been assessed on the premiums paid in the period from 1 September 1992 (where they are known) to 31 December 2000;

3. Lower of Stage 2 Loss and Absolute Loss ("Aggregated External Relative Loss")
 - Comprising the lower of the Absolute Loss and the Stage 2 Loss, at an individual policy level, where possible. This relates to the first step of the five step process which Sir John has identified in his Advice. The External Relative Loss therefore incorporates, for individual policies, the assessment of Absolute Loss. These estimates have been assessed solely on the premiums paid in the period from 1 September 1992 (where they are known) to 31 December 2000;
4. External Relative Loss multiplied by a factor to allow for Sir John's Advice as to the likely premium reduction ("Sir John's Advice before Internal Relative Loss (20%/25%)") -
 - Comprising the External Relative Loss, at an individual policy level, taking into account the proportions of External Relative Loss which Sir John advised should be applied (25% for with-profit annuity policies and 20% for all other policies), in Part 7 of his Advice, excluding any assessment of Internal Relative Loss. This relates to the second step of the five step process which Sir John has identified in his Advice;
5. External Relative Loss plus an assessment of Internal Relative Loss, each multiplied by factors to allow for Sir John's Advice as to the likely premium reduction which should be applied ("Sir John's Advice") -
 - This loss figure is the result of all five steps which Sir John identified in his Advice and is our estimate of loss based on Sir John's Advice. The figure shown here is, in aggregate, lower than that shown by Sir John's Advice before Internal Relative Loss (20/25%), shown in 4, due to the fact that some policyholders will have experienced internal relative gains on premiums paid prior to and during the early 1990s, but others will have experienced Internal Relative Loss, on later premiums. Therefore, including the Internal Relative Loss would more fairly distribute the losses amongst policyholders.

The results of 1 and 2 above are independent calculations. The figure described by 3 represents the aggregate, across all policies, of the lower of the Absolute Loss and Stage 2 Loss for each policy. The figure described in 4, is determined for each policy from 3 and multiplied by a factor (as advised by Sir John). For the final stage, the appropriate proportion of Internal Relative Loss is introduced which, as described above, whilst in aggregate it reduces the figure, it will increase the result for some policies and reduce it for others.

Estimates

Table 1 overleaf summarises our estimates of the loss based on Sir John's Advice and the intermediate steps, which are related to Sir John's five step process, and are used to illustrate the construction of the loss based on Sir John's Advice.

TABLE 1**Estimate of Loss on required bases**

Basis for estimate of loss	Estimate (£m)	Description of estimate
1. Aggregated Absolute Loss	2,900 – 3,700	Absolute Loss is derived as the difference between the payout (allowing for the guarantees in the policy terms) that would have been received (or would have been received in the future) by the policyholder in respect of the relevant Equitable Life policy if the final policy value cuts of 2001 and with-profit annuity cuts in 2003 had not occurred and the payout which has actually been received (or will be received in the future), in respect of the Equitable Life policy. The estimate is the aggregate across all policies.
2. Aggregated Stage 2 Loss	4,000 – 4,800	Stage 2 Loss is the difference between the payout which would have been received (or would have been received in the future) in respect of a comparable product offered by an alternative provider and the payout which has actually been received (or will be received in the future), in respect of the Equitable Life policy. The estimate is the aggregate across all policies.
3. Aggregated External Relative Loss	2,300 – 3,000	Comprising the lower of the Absolute Loss and the Stage 2 Loss, at an individual policy level, where possible. The estimate is the aggregate across all policies.
4. Sir John's advice before Internal Relative Loss (20%/25%) ⁽¹⁾	475 – 650	Comprising the External Relative Loss, at an individual policy level, taking into account the proportions of External Relative Loss which Sir John advised should be applied (25% for with-profit annuity policies and 20% for all other policies), excluding any assessment of Internal Relative Loss. The estimate is the aggregate across all policies.
5. Sir John's Advice	400 – 500	This loss figure is the result of all five steps, at an individual policy level, which Sir John identified in his Advice and is our estimate of loss based on Sir John's Advice. This figure includes an allowance for Internal Relative Loss, using the proportions of External and Internal Relative Loss as advised by Sir John. The estimate is the aggregate across all policies.

⁽¹⁾ 20% applied to all policy types except for with-profit annuities where 25% is applied.

The estimates set out in Table 1 (and Table 2 below) are subject to changes, as the process for checking the losses continues. In particular the losses may change as some of the areas of uncertainty, as detailed below, are clarified and if some of the assumptions change.

The loss calculated on the basis of Sir John's Advice (row 5 in Table 1) can be split between with-profit annuities and other policies (including accumulating with-profits policies and conventional with-profits policies), which were identified and described in Section 3 of the TW Advice, in the proportions set out below:

- 16% with-profit annuities; and
- 84% other policies.

These proportions are approximations as in practice it is not possible to strictly split the losses into the groups set out above due to the offsetting applied to calculate policyholder losses.

Further information

You have also asked us to provide further information: an assessment of the aggregate of the External Relative Loss for premiums paid after 1 September 1992 (where these are known) and Internal Relative Loss for all other premiums, set out in Table 2.

The figure shown in Table 2 has been estimated on the following basis:

6. External Relative Loss together with Internal Relative Loss for premiums paid prior to 1 September 1992 ("Aggregate External Relative Loss + Internal Relative Loss (pre September 1992)") -
 - Comprising the External Relative Loss, at an individual policy level, at row 3 in Table 1, together with an assessment of Internal Relative Loss, as described by Sir John in Part 6 of his Advice, but only arising on the policy values in respect of premiums paid prior to 1 September 1992, based on the performance of Equitable Life as if it had not been subject to the accepted instances of maladministration.

It should be noted that this figure cannot be derived from Sir John's Advice. It is based on an inherent contradiction. The figure for Aggregate External Relative Loss shown in row 3 of Table 1 is based on the assumption that Equitable Life received no new premium income after 1992: the calculation of Internal Relative Loss (based on Sir John's Advice) is based on the assumption that (absent maladministration) the Society would have received 75-80% of the new premium income that it did in fact receive during that period.

TABLE 2**Additional information on further stage in the assessment of loss**

Basis for estimate	Estimate (£m)
6. Aggregate External Relative Loss + Internal Relative Loss (pre September 1992)	1,900 – 2,600

The figure shown here is, in aggregate, lower than that shown by Aggregate External Relative Loss, shown in row 3 of Table 1, due to the fact that some policyholders will have experienced internal relative gains on premiums paid prior to and during the early 1990s; but others will have experienced Internal Relative Loss, on later premiums.

Assumptions

These estimates are based on a number of assumptions, including, where possible, those documented in Sir John's Advice and in the TW Advice.

Areas of uncertainty

The estimate above is subject to a number of uncertainties, in particular:

- The estimate has been prepared on the basis of policy and comparator data as at end 2007, (for all policies with the exception of with-profit annuity business which has been prepared on the basis of end 2009 comparator data). Sir John has advised that losses should be calculated based on policy data as close to the payment date as possible. For these policies we have calculated the losses up to the end of 2007 and rolled these forward to the end of 2009, to reflect the likely later end date. The losses will therefore change when the policy transaction data we have is updated to a later date, at which point the comparator data will also be updated to reflect a later date. This work is underway, with the assistance of Equitable Life;
- Although these estimates are based on policy level losses (a bottom up approach), there remain some product lines and categories of policies for which further analysis is required before we can assess the loss accurately at an individual policy (or policyholder) level. For example, Sir John noted in Part 4 of his Advice, and we explained in the TW Advice the difficulty of assessing losses for conventional with-profits policies. At this stage the total loss estimate includes a high level estimate, rather than an individual policy estimate, for conventional with-profits policies;
- There are a number of policies for which the loss is excluded due to unresolved data problems or inconsistencies. We have included an estimate of the losses for these policies within the figures above. We do not expect the losses in respect of these policies to cause the aggregate figures to fall outside the range highlighted above;
- A number of important decisions, which fall outside of the scope of Sir John's Advice, are required in order to determine the losses. For the purposes of these estimates we have made assumptions as to what these parameters are. However, it is important to recognise that the results will change as these decisions are made. For example, the estimate is based on allowing for interest on any loss payments from the earlier of the date of termination and the end of 2007, to the end of 2009, accumulated at 4%. This rate is approximately equal to the geometric average of the Barclays base rate over the relevant period;
- Sir John's Advice explains the approach which should be adopted to allowing for the various compensation schemes from which payments have been made to Equitable Life policyholders. At this

stage the loss estimate incorporates the compensation payments which are included on the database regardless of the type of scheme from which they originate. We do not expect this to have a large impact on the total aggregate relative loss;

- The TW Advice sets out some of the future relative loss assumptions which would be applied for with-profit annuities and conventional with-profits policies. Some of these assumptions may change, particularly the future mortality and discount rate assumptions;
- The estimate does not allow for any offsetting across group pensions policies. This is explained in Section 8.8 of the TW Advice; and
- No allowance has been made for the three factors which Sir John identified as giving rise to disproportionate impact to various classes of policyholders, which he described in Section 9 of his Advice.

Reliances and Limitations

In preparing the information within this letter we have relied extensively on data from a number of sources as set out in Section 9 of the TW Advice.

The values set out in this letter are estimates prepared following the delivery of Sir John's final Advice at the request of the Government. It should be recognised that these are initial estimates, prepared since the finalisation of Sir John's Advice and will need to be subject to further checking over the coming months. Additionally, they are subject to a number of assumptions as to decisions that will be made; to the extent that the final decisions made may differ from those we have assumed and any assumptions change the values included in this letter may change materially.

The loss estimates provided are also subject to the same limitations set out in Section 9 of the TW Advice.

Yours sincerely



Gavin Palmer

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