

The Office of Sir John Chadwick

Appointed by HM Government as independent adviser in relation to The Equitable Life ex-gratia payment scheme

From: The Right Honourable Sir John Chadwick

The Financial Secretary to the Treasury
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

25 May 2010

Dear Minister

Equitable Life

At our meeting last week I explained that I thought it appropriate to defer the completion and delivery of my Advice to the Government in order to enable interested parties to consider and respond to developments since the publication of my Third Interim Report: in particular, to the further provisional advice which I have now received from Towers Watson, my actuarial advisers. We agreed that I would write to you.

2. In section 2 of the interim report which I delivered in March 2010 – my Third Interim Report – I set out provisional conclusions in answer to questions raised by the requirement (introduced by the revised Terms of Reference laid before the House of Commons on 26 November 2009 as Cm 7762) that I advise as to the nature and extent of the maladministration and injustice in relation to the Ombudsman’s fifth finding and the nature and extent of the injustice in relation to her second and fourth findings (so far as those findings are now accepted by the Government). The questions are set out in summary form at paragraph 2.3 of the Third Interim Report. Put very shortly, they ask:

- (i) what would have been the effect on Equitable Life’s annual regulatory returns if GAD and the prudential regulator had taken the action which (absent the maladministration found and accepted) would have been taken in relation to the matters which are the subject of the Ombudsman’s findings;

(ii) how likely is it that – if such action had been taken – policyholders or prospective policyholders would have decided not to take out new policies, not to pay further money into existing policies, or (in so far as they were able to do so) to withdraw money from existing policies; and

(iii) when (if at all) policyholders would have taken such decisions.

3. At paragraphs 2.41 to 2.50 of my Third Interim Report, I set out a year by year analysis as to what Equitable Life's regulatory returns for the years 1990 to 1996 – and thereafter – would have been likely to show if GAD and the prudential regulator had taken the action which (absent the maladministration found and accepted) would have been taken. That analysis was based on provisional advice given by Towers Watson in a letter dated 3 March 2010 which is Appendix C to the Third Interim Report. As I explained, Towers Watson's advice was based on assumed scenarios: a "Lower Impact" and a "Higher Impact" scenario. The two scenarios provided a range of possible outcomes for the contents of Equitable Life's regulatory returns in the absence of maladministration. Towers Watson's advice was that the most likely outcome would lie within the bounds set by those two scenarios.

4. At paragraph 2.51 of my Third Interim Report I set out the conclusions which I was minded to reach on the basis of the provisional advice which I had then received. Sub-paragraphs (v) and (vi) of that paragraph are of particular importance. In those sub-paragraphs, I pointed out that, on the basis of the Higher Impact scenario, there was a real possibility that those who took out new policies or paid further money into existing policies following the publication of the regulatory returns for 1991 would have made different decisions (in 1992 and in subsequent years) if maladministration had not occurred; but that, on the basis of the Lower Impact scenario, policyholders' decisions would not have been materially different.

5. I emphasised, at paragraph 2.4 of my Third Interim Report, that the conclusions expressed in answer to the questions which I had summarised at paragraph 2.3 were provisional conclusions. I explained that Towers Watson had appointed a panel of external actuaries to review its work; and that I should need to revisit my provisional conclusions when that review had taken place. I should also need to take account of any further representations made to me in response to my Third Interim Report.

6. Since the delivery of my Third Interim Report there has been extensive discussion between Towers Watson and the panel of external actuaries in relation to the regulatory returns; and substantial representations have been made by

interested parties. In the light of those discussions and representations Towers Watson has developed a revised scenario. This is described in the further letter of provisional advice which I have received. A copy of that letter is attached.

7. The letter sets out, in some detail, the assumptions which have been made. It is, of course, recognised that it is impossible to say, with certainty, what action – whether by way of intervention under statutory powers, or by dialogue and persuasion short of intervention – GAD and the prudential regulator would have taken in the absence of maladministration; or (of equal importance) how Equitable Life would have responded to such action. But it is possible for actuaries with practical experience of with-profits life assurance business at the relevant time to make an informed assessment as to what would have been likely to have happened. This has been done. I am satisfied that – within the limitations which are inherent in what must be a counterfactual exercise – it is appropriate for me to rely on the revised scenario.

8. Subject to any further representations that I receive, I will use the revised scenario as a basis (with other factors) for answering the questions summarised at paragraph 2.3 of my Third Interim Report. I need to answer those questions if I am to carry out the task for which I have been appointed.

9. My present view is that the revised scenario points to the conclusion that some (but by no means all) of those who made payments into Equitable Life policies after 1992 would have decided not to do so. For those policyholders relative loss (“Head A loss”) is to be measured by the difference between the value of the policy which they had in Equitable Life and the value of a comparable policy (given the same payment history) in an appropriate comparator company. The difficulty, of course, lies in identifying which policyholders would have decided not to make payments into Equitable Life. I have explained, in my First Interim Report, why I think it impracticable (if not impossible) to seek to identify those policyholders (and the relevant payments) on an individual basis. I have received no representations which urge a contrary view. The only practicable approach, as it seems to me, is to seek to assess what the likely overall reduction of new money payments into Equitable Life would have been, year by year; and to treat each policyholder who did make non-contractual payments into Equitable Life as having suffered a corresponding proportion of Head A loss. The revised scenario is one factor to be taken into account in this exercise. But it is not the only factor. In addition to the findings in the Ombudsman’s Report (which are binding on me) I shall also take account of views expressed by the Ombudsman (both in her Report and subsequently), by which, strictly, I am not bound.

10. The relative loss suffered by policyholders who would not (or could not) have made decisions based on the regulatory returns – and so would have been policyholders in Equitable Life whether or not regulatory maladministration had occurred – is measured by the difference between the actual value of the policy which they had in Equitable Life and the value which that policy would have had absent maladministration (“Head B loss”). At paragraph 4.12 of my Second Interim Report, I expressed the view that the true comparator for the measurement of Head B loss was “Equitable Life as it would have been had the accepted maladministration not occurred”. In my Third Interim Report I noted this and expressed the view (at paragraph 4.6) that it would “not be sensible to attempt” to reconstruct such a comparator. But, given the degree of thought and work that my actuarial advisers have devoted to the revised scenario, and the degree of public and professional scrutiny to which their work has been exposed, I now take the view that it *is* appropriate to employ the revised scenario in the measurement of Head B losses.

11. In this context, I need to consider:

- (i) whether those who were policyholders in Equitable Life, and who would not (or could not) have withdrawn, have suffered loss as a result of maladministration prior to the date (December 2000) when Equitable Life closed to new business; and
- (ii) whether those who were, and who (absent maladministration) would have been, policyholders at the time of the closure to new business would have suffered policy value cuts (and, if so, in what amounts) during the years 2001 to 2003 had Equitable Life been regulated without maladministration (as found and accepted) during the previous decade.

12. It seems to me important that HM Treasury – and those who are, or who may be, affected by that Advice – should have the opportunity to make representations to me (if they wish) on the assumptions which underlie the revised scenario.

13. We agreed, in the course of our meeting last week, that I would publish this letter – by placing a copy on my office website and by sending copies to those who made representations in response to the provisional conclusions in paragraph 2.51 of my Third Interim Report – with the intent that those who wished to make further representations to me in writing should have the opportunity to do so.

14. Publication of this letter will provide a convenient opportunity to indicate those life companies that I am minded to include in the basket of comparators by reference to which Head A loss is to be measured. They have been chosen in accordance with the principles set out in that report. For pensions business, the

basket of comparators will comprise Friends Provident, Norwich Union, Prudential, Standard Life and Scottish Widows: for life business, the basket will comprise Legal and General, Norwich Union, Prudential, Scottish Mutual and Scottish Widows: for with profit annuity business, the basket will comprise Prudential and (from 1996 onwards) Scottish Widows.

15. I invite those who wish to make further representations to me to do so no later than Friday 11 June 2010; with a view to completing and delivering my Advice to Government by the middle of July.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Giddens', followed by a long horizontal flourish line.