

18 January 2011

Mark Hoban MP  
Financial Secretary to the Treasury  
Her Majesty's Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Dear Mr Hoban

### **Equitable Life Payment Scheme – Update of aggregated loss figures**

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"), we provided you with an initial estimate of the aggregate loss under Sir John's Advice, as well as the results of certain intermediate calculations that represent stages in reaching that aggregate loss estimate.

We produced an updated estimate to the loss figures to inform the Spending Review process, set out in our letter dated 19 October 2010. This letter updates the estimates we previously provided, incorporating modifications to the initial estimates as we have continued to enhance our calculations and further analyse the policyholder database in order to more accurately reflect the Relative Loss suffered by individual policyholders.

### **Basis of calculations and results**

The loss calculation is based on the following definition of Relative Loss:-

"Relative Loss is the difference in the value of a notional policy which the policyholder might have held had they made an investment in a similar product in a comparator company's with-profits fund and the value of the actual Equitable Life policy."

This Relative Loss corresponds to, and is calculated in the same way, as the loss previously defined as Aggregate Stage 2 loss, in our letter dated 19 October, and as such no other bases are considered in this letter.

Table 1 below summarises the Relative Loss, split by policy type, calculated as at 31 December 2010.

**TABLE 1**

**Estimate of Relative Loss by policy class (£m)<sup>1</sup>**

<b>Policyholder losses type</b>	<b>December 2010</b>
Individual (Accumulating With-Profit)	2,575
Individual (Conventional With-Profit)	50
Group pensions	835
With Profit Annuities	615
<b>Relative Loss (including offsetting within a policy class but before cross-class offsetting)</b>	<b>4,075</b>
Cross-class offsetting <sup>2</sup>	(5)
<b>Relative Loss (Aggregated Stage 2 Loss)</b>	<b>4,070</b>

<sup>1</sup> Losses are rounded to the nearest £5m

<sup>2</sup> This includes offsetting between groups AWP/CWP and WPA/non-WPA where WPA gains can only offset non-WPA losses.

The Relative Loss (Aggregated Stage 2 Loss) calculated at the time of the Spending Review was £4.3bn. This allowed for full offsetting with no restrictions. The equivalent Relative Loss at December 2010 is £4,052m but Table 1 shows the results reflecting the current offsetting allowance. This follows your decision of 20 October 2010 to cover WPA losses in full.

The change in the Relative Loss figure has been driven by continued improvements made to the calculations, refinements of individual policies' Relative Loss calculations, addressing data issues and on-going review of individual's Relative Losses. The changes should be seen in the context of total policy values which, for AWP business alone, is in excess of £30bn. These changes are described in more detail in the section below.

**Continued work on the loss calculations**

We have continued to develop, enhance and review the models used to calculate the individual losses since the Spending Review and this work is still ongoing. This work includes, but is not limited to, the following activities:

- Continuing to investigate reconciliation issues or unusual data for groups of coverages and for individual coverages. This has often involved corresponding with Equitable Life in order to obtain more data and/or in some cases developing modified approaches to dealing with group of coverages to improve their reconciliation and so calculated loss.
- Applying updated or revised data from Equitable life, for example:
  - The use of a new, more reliable data field ("WP effective date") to indicate the start date of a policy which may have influenced the eligibility of some coverages and also affected the loss calculation for policies where complete data is not available. This represented a relatively material change to Relative Loss.
  - Details of accumulating class business which was previously excluded by Equitable from the data

- WPA “failed” policies are grossed up in the aggregate loss figure by increasing the total WPA loss by a pro-rata factor which is based on the number of “fails” and the average loss for relevant policies. As more “fails” are resolved the grossing up figure is adjusted and we have also enhanced the approach used to gross-up.
- Corrections to allow for a small number of coverages which failed to run through the model at the time of the Spending Review.
- Continued review/amendment of minor assumptions to ensure they remain appropriate, e.g. equity-backing assumptions for CWP future loss calculations.
- Enhancements to the offsetting process to ensure coverage matching is appropriate and allow for previous compensation schemes and the use of WPA gains to offset non-WPA losses.
- Ongoing technical/peer review of the models including sample policy testing to test for robustness of calculations.

The most material changes in the results arises from:

- a change in the approach for the modelling of Equitable contractual payments where guarantees apply for eligible policies. This change is a methodology change and a model correction.
- Further information from Equitable Life regarding the interpretation of the data for “WP effective date”.

There are still model approach changes we expect to implement following decisions on the treatment of fail flags.

### Conclusion

We will continue to refine our approach and calculations over the coming months, during which time we expect there to be some further changes to the loss calculation. In particular, we are waiting for some decisions to be made by HM Treasury, for example on suggested treatment of fail flags, which will impact the calculation of Relative Loss. We expect the final relative loss figure to fall in the range of £4.1bn to £4.3bn

Yours sincerely



Gavin Palmer