

Private and Confidential

25 May 2010

Rt Hon Sir John Chadwick
1 Essex Court
London
EC4Y 9AR

Dear Sir John

You have asked Towers Watson (“we” or “us”) to analyse how the regulatory returns of The Equitable Life Assurance Society (“Equitable Life”) are likely to have been different if the instances of maladministration found by the Parliamentary Ombudsman and accepted by HM Treasury had not occurred.

In response to this request, we initially developed two scenarios, the “Lower Impact” and “Higher Impact” scenarios, which were described in a letter published with your Third Interim Report on 4 March 2010. Since then, we have held further discussions with you, various interested parties and our peer review panel about these scenarios. Inevitably in an exercise of this nature, there is unavoidable uncertainty as to what might have been the response of Equitable Life, absent maladministration. However, having reflected on the substance of these discussions, we have developed a scenario which we believe represents, subject to the assumptions set out below, a reasonable estimate of the likely performance of a reconstructed Equitable Life over the course of 1990 – 2000.

In this letter we set out the approach we have taken to developing this Revised Scenario, describe the assumptions that we have made and, in the appendix, we show a summary regulatory position for Equitable Life as it actually was (“actual Equitable Life”) and the reconstructed Equitable Life that we have developed (“Reconstructed Equitable Life”).

Approach

We have taken instructions from you on the approach that we should use in order develop a scenario for a Reconstructed Equitable Life. In particular, two key assumptions form our starting point for the scenario for the Reconstructed Equitable Life:

- That the actual management of Equitable Life (including Roy Ranson and Chris Headdon) that was in place over the relevant period would also have been in place for the Reconstructed Equitable Life; and that they would have sought to pursue the same business strategies as were actually employed – to the extent that the regulator permitted them to do so.
- The regulator would have acted in accordance with what was considered to be an acceptable standard of good administration during the period in question. While this would have gone beyond merely ensuring that Equitable Life complied with all the relevant regulations, it would not necessarily involve following what would now be considered to be best practice.

In addition we have employed a number of other overarching assumptions in our approach:

- We have focussed our analysis on Equitable Life’s Appendix valuation, as this is the valuation required by regulation (as discussed in the Third Interim Report at paragraph 2.29).

- We have assumed that the regulator would have been concerned with policyholders' reasonable expectations ("PRE") and that for Equitable Life these expectations included 'full and fair distribution'.
- We have assumed that Reconstructed Equitable Life's management could take the following actions to improve its surplus position:
 - Take greater credit for an Implicit Item
 - Reduce equity backing ratio ("EBR")
 - Reduce declared bonus rate and make changes to the final bonus rate.

We have assumed that, broadly speaking, the order of preference in which Reconstructed Equitable Life's management would take these actions would be the order presented above. This leaves out various other actions that the management could have taken, such as making greater use of subordinated debt and or reinsurance. However, we have assumed that these actions were not taken. This is because it is possible that greater use of subordinated debt might have been seen as a sign of financial weakness. The cost of reinsurance may have been sufficiently costly that it would bring no net benefit to Reconstructed Equitable Life's returns (see the Third Interim Report, paragraph 2.38).

- Equitable Life's actual management ran the business in accordance with its own business objectives. We have assumed that Reconstructed Equitable Life would have carried on its business in the same way that actual Equitable Life did, including:
 - A focus on sale of new business
 - Full distribution of surplus (where possible)
 - Running a minimal estate
- We have assumed that following the publication of the regulatory returns in each year the returns were scrutinised by GAD / the regulator and that any changes the regulator sought in Reconstructed Equitable Life's returns would then be reflected in the subsequent year's returns, but would not lead to a re-submission of the returns.

For example, the 1990 year end regulatory returns became public in June 1991. GAD initially scrutinised the returns in July 1991 and then submitted detailed scrutiny in November 1991. We have assumed that following scrutiny of these returns, GAD or the regulator enters into a dialogue with Reconstructed Equitable Life during the course of 1991 in order to seek changes in Reconstructed Equitable Life's returns for end 1991.

We have then assumed that this dialogue occurs in time to enable Reconstructed Equitable Life to make changes to its balance sheet before the end of 1991 (with exception of changing bonus rates as these occur after the year end). For example, should Reconstructed Equitable Life's management deem it necessary to alter its EBR, it is able to do this in time to have an impact on the year end balance sheet and regulatory returns. For 1991 in particular, we have assumed that Reconstructed Equitable Life moves to a lower EBR than actual Equitable Life and declares a lower bonus rate.

The timing of the interactions between Equitable Life's management and the regulator is discussed in greater detail in the Third Interim Report (paragraphs 2.5 – 2.11).

- We have assumed that Reconstructed Equitable Life would not have sought to demutualise or sell itself until it had no other options.

Assumptions

In the course of developing a scenario for Equitable Life we have made a number of more detailed assumptions and we have recorded the material of these assumptions below. The first set of assumptions that we describe relates to the Parliamentary Ombudsman's findings of maladministration that have been accepted by the Government and the way that the regulator could have avoided this maladministration. The second set relates to actions that Reconstructed Equitable Life's management are assumed to take.

Assumptions on maladministration

For convenience we have noted the finding to which each assumption relates.

- **Findings 2 & 4 on affordability and sustainability of bonus rates:** as mentioned above we have assumed that the regulator would be concerned with Equitable Life's ability to meet PRE. This is particularly the case in light of the fact that Equitable Life's ratio of aggregate with-profits policy values to total with-profits assets at end 1990 was 128%¹.

We have assumed that following a discussion with the regulator about PRE, Reconstructed Equitable Life agrees to demonstrate to the regulator each year that over the course of the next 5 years it can, using reasonable assumptions on total returns and future reversionary bonus rates, bring the ratio of aggregate with-profits policy values to total with-profits assets down to 100%.

We have assumed that the timeframe of 5 years is a compromise reached between Reconstructed Equitable Life and the regulator at the end of a dialogue between them. The timeframe of 5 years for bringing the ratio of aggregate policy values to total with-profit asset values down to 100% has been chosen as it is a reasonable period of time over which an insurance company could effect this change without unduly disturbing its smoothing policy. In addition, if a shorter period of time were chosen, such as 2 years, the volatility of financial markets could cause very low bonuses to be declared. A much longer timeframe, such as 10 years, is so long that the demonstration that the ratio can be brought down to 100% is not meaningful.

As 5 years is neither a very short nor very long period in the context of the operation of a life insurance company it is a reasonable period over which to effect a change in the ratio of aggregate policy values to total with-profit asset values.

This demonstration provides a ceiling to the bonus rates that can be paid by Reconstructed Equitable Life. This causes reductions in reversionary bonus rates in 1991 and 1992.

- **Findings 2 & 4 on valuation interest rates ("VIR"):** we have estimated that the margin between Reconstructed Equitable Life's yield on assets and VIR in 1990 was 0.96%. We have assumed that Reconstructed Equitable Life's VIR in the period 1992 – 1996 should be no lower than 1.00%.
- **Finding 4 on GAR reserves:** we have allowed for GAR reserves to be held in 1995, 1996 and 1997 (although no finding in 1997). These GAR reserves assume the same take up rate assumption as that actually used by Equitable Life for the 1998 year end (take up rates of 70.0% - 82.5% depending on the type of policy). This assumption is on a statutory / regulatory basis and is therefore intended to be prudent (as opposed to the commercial cost basis which is akin to a best estimate).
- **Finding 4 on the retirement age assumption for PPP policies:** we have assumed that the regulator would have required Equitable to use a retirement age of 50 for PPP policies in its base valuation scenario. However, we have assumed that Reconstructed Equitable Life would have been allowed to use a retirement age assumption of 55 in the resilience scenario.
- **Finding 5 on information omitted from the regulatory returns:** We have assumed that Reconstructed Equitable Life's resilience reserve in 1995 would have been approximately £400m.
- **Finding 6 on financial reinsurance:** We have assumed that Reconstructed Equitable Life can take no credit for the IRECO treaty in 1998, 1999 and 2000. Therefore we have given Equitable no credit for the reductions in GAR reserves shown in the regulatory returns for those years. In addition, we have assumed that if credit for the IRECO treaty is reduced then Reconstructed Equitable Life would have to re-hypothecate lower yielding assets to support its higher liabilities, reducing its VIR. This causes a 'second round' effect of the removal of the IRECO treaty that causes a further weakening of Equitable Life's surplus position.

¹ Penrose, Table G.5

Assumptions on management actions

We have recorded below the key assumptions that we have made in setting the actions that we assume to be taken by the Reconstructed Equitable Life.

- We have assumed that Reconstructed Equitable Life would be able to take credit for an implicit item in its regulatory returns of up to 5/6^{ths} of its required minimum margin ("RMM").
- We have assumed that the management of Reconstructed Equitable Life would intend that the RMM of Reconstructed Equitable Life should be no lower than the average RMM of the 5 companies with the lowest RMMs in the market and that the management would take actions to ensure that this was the case.
- We have assumed that reductions in Reconstructed Equitable Life's EBR (compared to those of the actual Equitable Life at the same year end) would have reduced its return on assets and affected the resilience reserve.
- We have assumed that reductions in reversionary bonus rates (compared to those distributed by actual Equitable Life) would have reduced liabilities in the regulatory returns and reduced claims paid out.
- We have assumed that reductions in final bonus rates (compared to those distributed by actual Equitable Life) would have reduced claims paid out.

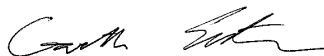
Further assumptions / conclusions

- The results of our analysis indicate that there was no real possibility that Reconstructed Equitable Life would have successfully sold itself in 2000 and that it is therefore likely to have closed to new business in 2000, just as the actual Equitable Life did.
- We have assumed that Reconstructed Equitable Life would have paid lower bonuses during the 1990s than the actual Equitable Life did. It seems likely that this would have caused *some* reduction in the premiums flowing into Reconstructed Equitable Life (compared to the actual Equitable Life). It is unnecessary, in the context of forming a view as to what the regulatory returns of Reconstructed Equitable Life would have shown, to quantify this reduction with any precision. We have not completed our analysis but our work thus far indicates that reasonably lower new business volumes do not materially alter our conclusions.
- We have assumed that Reconstructed Equitable Life would have had to contend with the Hyman ruling by the House of Lords at the same time as actual Equitable Life did and that it would react to the ruling in the same way.
- We have assumed that in July 2001 Reconstructed Equitable Life would have sought to bring its policy values into line with assets, just as actual Equitable Life did.

Yours sincerely



Gavin Palmer



Gareth Sutcliffe

TABLE 1

Revised Scenario – summary balance sheet

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Actual Equitable Life											
Surplus	456	497	858	1,802	1,297	2,134	1,737	2,123	2,524	3,861	1,632
RMM	233	293	357	458	494	586	685	845	1,008	1,114	1,221
RMM Cover	196%	170%	240%	394%	262%	364%	254%	251%	250%	347%	134%
Non-linked FAR	8.3%	7.2%	9.7%	14.6%	8.4%	12.3%	8.3%	8.2%	6.7%	10.1%	2.1%
Reconstructed Equitable Life											
Surplus	456	457	746	1,675	1,205	1,744	1,975	2,429	2,243	3,730	1,463
RMM	233	295	362	465	510	615	707	863	1,036	1,143	1,233
RMM Cover	196%	155%	206%	360%	236%	283%	279%	281%	216%	326%	119%
Non-linked FAR	8.3%	6.6%	8.4%	13.4%	6.2%	8.0%	8.0%	7.9%	5.4%	9.5%	1.5%

RMM = Required Minimum Margin

Non Linked FAR = Free Asset Ratio for Non Linked business

Note that the Non-linked FAR is lower in most years for Reconstructed Equitable Life than for Actual Equitable Life. The reason for this is that in most years the adjustments for maladministration have a larger effect than the management actions taken to improve the surplus position.

TABLE 2

Revised Scenario - changes to bonus rates

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Actual Equitable Life											
Actual GIR	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Actual RB	7.5%	6.5%	5.0%	4.0%	4.0%	4.0%	4.0%	3.0%	1.5%	1.5%	0.0%
Actual FB	1.0%	2.0%	1.5%	5.5%	2.5%	2.5%	2.5%	6.5%	5.0%	7.0%	0.0%
Actual Overall Bonus Rate	12.0%	12.0%	10.0%	13.0%	10.0%	10.0%	10.0%	13.0%	10.0%	12.0%	3.3%
Reconstructed Equitable Life											
Reconstructed GIR	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Reconstructed RB	7.5%	4.5%	4.5%	4.0%	3.5%	3.0%	3.0%	3.0%	1.0%	1.0%	0.0%
Reconstructed FB	1.0%	1.0%	1.0%	5.5%	1.0%	3.0%	3.5%	5.5%	5.5%	7.5%	0.0%
Reconstructed Overall Rate	12.0%	9.0%	9.0%	13.0%	8.0%	9.5%	10.0%	12.0%	10.0%	12.0%	3.3%

GIR = guaranteed interest rate

RB = Reversionary bonus rate

FB = Final bonus rate