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Dear Sir

## Equitable Life Payments Scheme - Pre-action Protocol for judicial review claims

### Introduction

1. We are instructed by the Equitable Members Action Group Limited (EMAG). They have asked us to write to you about the Government's decisions relating to compensation of policyholders in the Equitable Life Assurance Society who suffered relative loss as a result of the maladministration found by the Parliamentary Ombudsman in her report entitled 'Equitable Life: a decade of regulatory failure'. Those decisions were announced as part of the comprehensive spending review on 20 October 2010. For the reasons set out in this letter, we consider that certain aspects of those decisions are unlawful.
2. EMAG was formed as an unincorporated association days after the ruling of the House of Lords in *Hyman v Equitable Life Assurance Society* on 20 July 2000. It is now a company limited by guarantee comprising approximately 40,000 present and past Equitable Life policyholders. Its objects are to further the interests of members and former members of Equitable Life, and those having or formerly having had interests in its with-profits policies. It has been closely involved in the Ombudsman's investigation throughout all its stages. It brought judicial review proceedings in respect of the previous Government's response to the Ombudsman's report, and it has made submissions to Ministers and to the Public Administration Select Committee. EMAG will be the claimant in any claim for judicial review which may be brought. It has standing to bring a claim in respect of these decisions.

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## Background

3. While in opposition, both parties to the Coalition accepted all the Ombudsman's findings of maladministration and injustice. At the General Election, they made manifesto commitments to implement the Ombudsman's central recommendation that the Government should establish and fund a compensation scheme with a view to providing appropriate compensation to those who had been affected by the events covered in her report. In her report (at page 394) the Ombudsman explained that:

139 The aim of such a scheme should be to put those people who have suffered a relative loss back into the position that they would have been in had maladministration not occurred.

140 Addressing relative loss in this way would remedy any financial loss that has occurred and also the loss of opportunities to invest elsewhere than the Society. It is thus the most appropriate remedy for the injustice that I have found resulted from maladministration.

The Ombudsman recognised that any scheme of compensation must balance the interests of Equitable Life policyholders against the burden on taxpayers.

4. The Coalition's Programme for Government, adopted after the election, repeated the promises made by the Conservative and Liberal Democratic parties, pledging that:

We will implement the Parliamentary and Health Ombudsman's recommendation to make fair and transparent payments to Equitable Life policy holders, through an independent payment scheme, for their relative loss as a consequence of regulatory failure.

5. That was a clear and unequivocal promise.
6. A number of features emerge from the announcement on 20 October 2010:
  - a. The Government says that it has accepted all of the Ombudsman's findings of maladministration and injustice and her recommended basis for compensation of relative loss;
  - b. It has adopted a figure of £4.3 billion as the amount of the relative loss attributable to the maladministration which the Ombudsman has found. This figure is based on the work of Towers Watson;
  - c. It has said that it will make £1.5 billion available for the Equitable Life Payments Scheme to compensate policyholders. £1 billion has been set aside for the three years of the current spending round, with another £500 million intended to be paid thereafter;
  - d. It proposes to compensate in full the losses of with-profit annuitants (WPAs) who invested in Equitable Life after 1 September 1992, but not those who took out their annuity policy earlier. Towers Watson estimate the cost of this as around £620 million, to include future losses;
  - e. The payments will be scheduled as follows:

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- Year 1: £500 million, including £72 million for WPAs;
  - Year 2: £300 million, including £72 million for WPAs;
  - Year 3: £200 million, including £71 million for WPAs;
- f. The balance of the fund to be made available for non-annuitants, however, is not £880 million (i.e. £1.5 billion less £620 million for the annuitants). In fact it is apparently only £775 million (see the Commission's revised terms of reference), because the post-comprehensive spending review figure of £500 million includes a contingency of £100 million, which is not part of the £620 million for WPAs. This means that, if one accepts Towers Watson's figure for relative loss, non-annuitants will receive on average about 21% of their losses according to Towers Watson's calculations (£775m of compensation for losses of £3,680 million);
- g. Distribution of the rest of the funds, apart from those for WPAs, is to be determined on the basis of recommendations and advice from the independent Commission, whose terms of reference have been revised accordingly.
- h. The Government considers that this scheme fulfils its promise.
7. In his statement to the House of Commons on 20 October the Chancellor of the Exchequer repeated that the Government has accepted all of the Ombudsman's findings and recommendations in full and is purporting to implement them. He also made clear that the Government has rejected Sir John Chadwick's alternative methodology for ascertaining relative loss, and that it agreed with the Ombudsman that the relative loss suffered is the difference between what policyholders actually received from their policies and what they would have received had they invested elsewhere. Either the Government's proposed scheme fulfils its promise or it does not. This is not, therefore, a case in which it is necessary to explore the cogency of the reasons for departing from the Ombudsman's findings, because the Government does not claim to be making any such departure. On the contrary, it claims to be meeting the legitimate expectation which it has created by its promise - a promise which has not been withdrawn or modified.
8. For the reasons set out in this letter, we consider that the decisions made as part of the comprehensive spending review fail to fulfil the Government's clear and unequivocal promise. We will consider the issue under the following heads:
- a. Valuation of loss:
- i. the valuation is based on the advice of Sir John Chadwick, whose terms of reference were limited to considering the findings of maladministration and injustice which the previous Government had accepted (paragraphs 15 - 16 below);
  - ii. although the Ombudsman recommended that policyholders be compensated in respect of all premiums paid after 1 July 1991, the quantification of relative loss has excluded all premiums paid during the 18 months between 1 July 1991 and

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31 December 1992 (for non-WPA policies) and all payments made by WPAs between 1 July 1991 and 1 September 1992 (WPA policies) (paragraphs 19 - 34 below);

- iii. the computation of loss wrongly disregards the costs of reinvestment in an alternative company and wrongly deducts exit costs from the results of the comparator company (the non-contractual market value adjustment or MVA) (paragraphs 35 - 39 below);
- iv. the computation wrongly fails to include the losses incurred by pre-1992 WPAs in quantification of the total relative loss (paragraph 41 below);
- b. the relative levels of payment to WPAs on the one hand and to non-annuitants on the other are unfair (paragraphs 42 - 49 below);
- c. Those who took out their WPA (whether by transferring in or crystallising an existing Equitable Life with profits policy) before 1 September 1992 are completely excluded from the scheme of compensation (paragraphs 50 - 65 below);
- d. the Government has frustrated a legitimate expectation of consultation and transparency by removing from the independent Commission questions as to fairness between WPAs on the one hand and other policyholder classes on the other (paragraphs 66 - 79 below).

#### **Valuation of the loss**

- 9. In the course of our correspondence with the Treasury over the summer, we made clear that in order to assess what is fair compensation, the Treasury must first arrive at a reliable figure for relative loss. Only once it has determined this figure can it address the question of what is a fair balance between policyholders and taxpayers.
- 10. The Treasury has accepted this point. In his Written Ministerial Statement dated 20 October 2010, the Financial Secretary said:
  - A commitment to fair payments must be founded on a fair assessment of the losses suffered by policyholders, and that must start with the Ombudsman's approach.
- 11. A flawed assessment of relative loss is therefore open to challenge if the methodology is irrational, or if it is inconsistent with the Coalition's promise to implement the Ombudsman's recommendations. Our clients consider that the assessment of relative loss which the Government has adopted discloses significant flaws that make a substantial difference to the total value of the loss to be taken into account. As a result, the Government has understated relative loss by about £1.9 billion, or approximately 44% of the accepted figure. Put the other way round, the Government's accepted loss figure is only 69% of the true relative loss.

12. While welcoming the broad consensus on a loss figure of £4 to £4.8 million, PASC's report of 15 October 2010 drew attention to EMAG's view that this is a considerable understatement and added (at paragraph 20 of its report of 15 October 2010) that:

The only way this disagreement can be resolved is if Towers Watson are instructed to recalculate their estimate in line with the Ombudsman's findings.

13. No such recalculation has been undertaken.

14. Against this background, we invite your response on the following.

*The calculation of relative loss by Towers Watson based on Sir John Chadwick's terms of reference*

15. Sir John Chadwick's terms of reference excluded those findings of maladministration or injustice which the previous Government had not accepted. As a result, Towers Watson's figures understated the true value of relative loss. For example,

- a. the exclusion of Finding 1 (about the dual role of the Appointed Actuary) was important to Sir John Chadwick's conclusion that the absence of maladministration would have made no difference to Equitable Life's management strategy. While the Ombudsman found no injustice flowing from Finding 1, allowing the dual role of the Appointed Actuary undoubtedly formed part of her conclusions as to the general consequences of all her findings of maladministration taken together (see paragraph 27 below). By contrast Sir John, because of his limited terms of reference, rejected suggestions that the questions and challenges which would have been put to the Society by the regulators would have led either to a change in management personnel or to greater involvement by the Board in decisions taken by its actuarial managers (see, for example, paragraph 3.14 of his Advice).
- b. Sir John's restricted terms of reference influenced the start date for the computation of loss and the Financial Secretary's claim that WPAs investing before 1 September 1992 made relative profits. This conclusion appears to be based on Sir John Chadwick's concept of internal relative loss, which is different from the Ombudsman's understanding of relative loss.

16. The Financial Secretary is therefore in error when he asserts - as he does in his Written Ministerial Statement of 20 October - that the relative loss calculation made by Towers Watson is not affected by Sir John Chadwick's restricted terms of reference.

17. On 14 October 2010, PASC put this matter to the Financial Secretary, who indicated that he had decided not to amend Sir John's terms of reference. PASC recommended that the Government re-engage Sir John Chadwick to establish what conclusions he would reach under terms of reference which reflect all ten of the Ombudsman's findings (paragraph 48 of its report of 15 October 2010) and it indicated that

If the Government's proposals remain based on Sir John's existing terms of reference we concur with the Ombudsman that they are in principle, an "unsafe and unsound" basis on which to proceed.

PASC was quoting from the letter which the Ombudsman sent to all Members of Parliament on 26 July 2010, in which she said that because of his limited terms of reference, Sir John Chadwick's proposals "seem to me to be an unsafe and unsound basis on which to proceed".

18. The Government has not asked Sir John - or Towers Watson - to undertake the task suggested by PASC. The Committee's criticism therefore remains.

*Start date for computation of loss*

19. The Government's announcement accepts Towers Watson's calculations of relative loss, which it describes as:

...the difference between what Equitable Life policy holders who invested from the end of 1992 onwards received from their policies, and what they would have received if they had invested elsewhere. (See the FAQs published on 20 October 2010)

20. The reasons for taking this date - which is loosely defined - are said to be two-fold. In the FAQs it is said:

The maladministration found by the Ombudsman affected regulatory returns from those for 1991 onwards. The 1991 return would not have had an effect on investors' behaviour until mid-1992. In addition the necessary data to operate the scheme is not available prior to end of 1992. (emphasis added)

21. In his letter to the Chair of EMAG dated 20 October 2010, the Financial Secretary says that

...due to the process by which regulatory returns were reported, no policyholder would have had the information available to them, that would cause them to leave Equitable Life prior to this date [1 September 1992], even if maladministration had not occurred.

22. In its response to PASC, the Government says that:

1.14 In respect of the start date, there are two substantial reasons for using the end of 1992 - one is an interpretation of the Ombudsman's findings, and the second is a practical consideration. As Sir John set out in his report, the information in the regulatory returns for the year 1991 that could influence policyholder behaviour "could not have come to the attention of policyholders and prospective policyholders before it was submitted at the end of June 1992". Sir John proposes that as such, it is unlikely that they would have influenced policyholders much before 1 September 1992.

23. The choice of 1 September 1992 (for WPAs), or the end of 1992 (for other policyholders)<sup>1</sup>, derives not from the Ombudsman's findings but from the Advice of Sir John Chadwick relating to his creation of reconstructed Equitable Life. He advised, at 4.49, that

...the regulator (acting without maladministration) would not have insisted on the amendment and republication of the Society's return for

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<sup>1</sup> The different start dates adopted for WPAs and other classes of policyholder appears to have been influenced by the availability of data.

the year 1990: rather, the regulator would have required that the concerns raised by the scrutiny of the return for year 1990 would receive attention in the regulatory return for year 1991.

24. This conclusion is inconsistent with the Ombudsman's findings of maladministration and injustice, which the Government has accepted. The Ombudsman found maladministration starting with the scrutiny of the 1990 regulatory return, which was filed on 30 June 1991. We are instructed that the 1990 Return was the most flagrantly misleading. Both the Ombudsman and Lord Penrose found that the regulators knew of Equitable's difficulties before 1990 ended, and that had they taken action earlier, possibly using their enforcement powers, they could have demanded a big reduction of the 1990 bonus before it was declared (see the chronology at pages 39-45 of Part 3 of the Ombudsman's report).
25. The Ombudsman summarised her findings of injustice for this period at page 375, paragraph 181 (Part 1 of the report), where she said:
- (i) that injustice was sustained by any policyholder who can show that they relied on the information contained in the Society's returns for 1990 to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision about their financial affairs as a result of such reliance;
  - (ii) that policyholders sustained injustice in the form of the loss of opportunities in the period between July 1991 and April 1999 to take informed decisions about their financial affairs in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated;
26. The Ombudsman also found a number of general consequences (paragraph 59 on page 341), including the following:
- the first was that the Society's published returns were unreliable;
  - the second was that there were lost opportunities to address critical issues earlier; and
  - the third was that regulatory decisions were taken on a basis which had insufficient regard to the range of powers that the prudential regulators possessed.
27. In its judgment of 15 October 2009 in *R (Equitable Members Action Group) v H.M. Treasury*, the Divisional Court summarised the findings as follows:
79. As to the first, she considered that the published returns "materially understated the Society's liabilities in several respects" and that this would have misled those seeking to assess the financial strength of the Society:
- "Anyone investing in the Society - whether as a new investor or as someone making a further investment in it - from the second half of 1991 onwards was at risk of being misled, if he had regard to the regulatory returns, about the financial condition of the Society. The prudential regulators permitted returns to be published which those regulators could not have been satisfied

revealed the Society's true liabilities or an accurate financial picture" (para 62-3)

80. As to the second, if the prudential regulators had raised concerns at an earlier date -

"... the resulting problems might have crystallised earlier and before they became so acute... some of those factors might have been ameliorated by earlier action... instead they developed over time to become intractable..." (paras 69-70).

81. This led to her determination of injustice, arising from the maladministration found in *findings 2, 4 and 5*:

"100. I find that injustice was sustained by any policyholder who relied on the information contained in the Society's returns for 1990 to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision as a result of such reliance. Where a policyholder neither relied on this information nor suffered a loss of either type, I find that no injustice resulted from this maladministration."

28. The Ombudsman reiterated her findings in her exchange of correspondence with Sir John Chadwick (see her letter of 27 November 2009). The Government says that it has accepted her findings, and is seeking to compensate for relative loss as a consequence of the regulatory failure which she had found. However, in adopting a start date of September 1992, it appears to have accepted Sir John Chadwick's advice that even without maladministration, the 1990 return would not have been different.

29. This approach appears to espouse the reasoning that the last Government adopted in rejecting the Ombudsman's finding of injustice in Finding 2, where it said (Cm 7538, paragraph 4.39):

"...the Government considers that there is no sound basis for considering that an attempt by GAD to investigate this issue [valuation rate of interest] would have resulted in any changes to the contents of Equitable Life's regulatory returns in the relevant years [1990 and 1991]."

30. The Divisional Court rejected the previous Government's approach, largely because it entirely disregarded the Ombudsman's findings about the general consequences of the maladministration. In its judgment, the Court said:

86. If that is the correct interpretation of the Ombudsman's report, then it is hard to criticise the response. However, it seems to us important to read this part of the Ombudsman's report as whole. The actual finding of injustice must be seen in the context of the preceding discussion. Viewed in that light, it seems to us that the thrust of the claimants' submission is correct. The finding of injustice was directed to the impact of the returns on those relying on them, because that was the mechanism by which the Ombudsman moved from the general

adverse effects of the maladministration, to the “injustice” suffered by particular individuals. However, she clearly saw that issue as directly connected with the general failures to which she had referred earlier in the same chapter. Otherwise, there would have been no purpose in mentioning those “consequences” as part of the immediate background to her finding of injustice.

87. Implicit in that approach seems to be the view that, if the problems had been identified and addressed at an earlier date, the inherent weaknesses of the Society’s position would not only have been brought to light, but would have been reflected in some way in its published returns, so that those relying on the returns would have had a more accurate picture on which to base their decisions. It is also apparent from her earlier comments that she accepted that this might have involved more than the bare minimum necessary to meet the regulatory requirements. It is true that she did not spell out the mechanism by which this would have been achieved, nor the precise form which the better information would have taken in the returns. But she clearly saw the regulator’s duty as going beyond that of securing minimum compliance, and as including a duty not to permit returns to be published which they -

“...could not have been satisfied revealed the Society’s true liabilities or an accurate financial picture.”

31. The start date for the assessment of relative loss which the Government has adopted cannot be reconciled with the promise to implement the Ombudsman’s findings and recommendation.
32. The relative loss for the early years is greater, since substantial premiums paid in this period remained invested in Equitable Life throughout the 1990s. Our clients estimate that the additional losses approximate to £700 million if the start date is 1 July 1991, as the Ombudsman found it should be. Setting the start date at 1 September 1992, or 31 December 1992, results in a substantial understatement of the loss, in a way which is inconsistent with the Ombudsman’s finding.
33. The second reason - the alleged non-availability of data - does not justify disregard for the Ombudsman’s findings. We are instructed that the Chief Executive of Equitable Life has made clear that substantial information does exist, from which extrapolations backwards might be made relatively easily; and the absence of digitised data in the same form is not an acceptable excuse for excluding these losses from the overall quantification. Sir John Chadwick (on whose advice this is based) made no attempt to ascertain what could be done with the existing data. Equitable Life has informed EMAG that the available data for WPAs could certainly be used to calculate their losses individually. The WPA contract is essentially a single premium product, whose structure is set at the outset, so reconstructing earlier events from later data is not a serious problem. While the data for non-WPA products, especially the dominant pension policy, is more difficult to reconstruct - because the policyholder had the option to pay premiums of an

amount and at a time to suit him or her - it is still possible to make a reasonable estimate of loss based upon aggregate premium payment figures in the accounts and from the information transferred from the old computer records to the new.

34. Sir John Chadwick's instruction to exclude all premiums paid during this period and right through to the end of December 1992 (WPAs to the end of August 1992) means that Towers Watson have attempted no such reconstructions or estimates.

*Market value adjustment (MVA) and re-investment costs*

35. Towers Watson's calculations take account of the MVA, or exit cost. The Government has adopted this. Its reasoning is explained at paragraphs 1.17-1.19 of its response to PASC as follows:

1.17 Guarantees that bite when policies are withdrawn contractually are based on the guaranteed value of the policy. These guarantees build up over the lifetime of the policy based on smoothed investment returns. On contractual exit the policyholder will receive the greater of the guaranteed value and the smoothed value of the underlying assets.

1.18 An (MVA) or 'exit cost' adjusts the policy value on earlier exit to calculate the actual value of the underlying assets at the point of withdrawal, where asset values have reduced due to market movements.

1.19 Applying an MVA means that no single policy holder can withdraw more than their assets are actually worth. This is the appropriate comparator to ensure that like is being compared with like between Equitable Life and the basket of comparators. Adjusting the value in this way avoids paying for investment performance whilst allowing for the effect of maladministration. If the impact of the MVA were removed from the calculation, policyholders would be compensated for investment performance.

36. Applying an MVA to a notional early departure from an alternative insurance company artificially depresses the valuation of policyholders' relative loss to a material extent, and it is inconsistent with the professed aim of arriving at a reliable figure on which to base the assessment of compensation for relative loss. It involves making a deduction for non-contractual exit from the figure which a policyholder would have earned had he invested with a properly regulated company. The FSA and the FOS have made no such deductions when making compensation awards to Equitable Life policyholders.

37. As the Financial Secretary's statement accepts, the starting point must be Ombudsman's concept of relative loss:

that is the difference between what Equitable Life policyholders actually received from their policies, and what they would have received if they had invested elsewhere. The representations I have received over the summer from policyholders and their representatives have overwhelmingly supported this definition, and I believe that it is the right basis for calculating loss.

38. Several hundred thousands of policyholders left Equitable Life between 2002 and 2005, when they realised its true financial position. They did this to mitigate their losses by investing their

funds elsewhere. Had they left their policies with Equitable Life, they might well have lost even more. Those who left non-contractually incurred exit costs when they transferred their policies elsewhere. Many also incurred re-investment costs, e.g. broker's commission on transfer. These charges for non-contractual exits from Equitable Life particularly affected late joiners, for whom substantial exit costs formed a large part of their total loss. Any assessment of the loss of those who transferred their policies must take account of these deductions because "what Equitable Life policyholders actually received from their policies" is what they were able to take away when they left to mitigate their losses (if they left). For the same reason, reinvestment costs depleted their investment in an alternative company.

39. There is no rational basis on which "what they would have received if they had invested elsewhere" should assume an early exit and make a similar deduction. On the contrary, the only reasonable assumption would be that they would have had no cause to make an early exit from a properly managed and regulated insurance company, and that their funds would have been invested until maturity. In that event, they would have received their contractual entitlement without any market value adjustment for earlier exit, and they would not have incurred any re-investment costs.
40. Our clients estimate that penalty costs and re-investment costs each account for another £500 million of loss, or £1 billion in total. This amounts to a very substantial understatement of the amount of relative loss.

*Failure to count the losses of pre-1992 WPAs*

41. Towers Watson's calculation of relative loss excludes WPAs who invested between 1987 (when Equitable Life first introduced the policy) and July 1991, the start date of the Ombudsman's findings of injustice. For the reasons set out below (see paragraphs 50 - 65 below), we consider that there is no rational basis for excluding this group of investors from the compensation scheme. Our clients estimate that the relative losses of this group, including future losses, are of the order of £200 million.

**Levels of payment to WPAs and to non-annuitants**

42. The Coalition's promise was to implement the Ombudsman's central recommendation to make "fair and transparent payments" to all those who have suffered loss. It also agreed with the Ombudsman on the need to need to deliver "as speedy a remedy as is possible" (paragraph 151 at page 396).
43. The scheme which the Government has decided on compensates some (but not all) WPAs for 100% of their loss while compensating some (although not all) non-WPAs for an average of 21% of their loss. In addition, payments are to be spread over three years, with WPAs receiving three payments for losses to date and regular payments thereafter, rather than a lump sum to represent what they have already lost.

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44. We do not consider that the scheme can be said to fulfil the Government's promise of "fair" compensation; nor does it strike a fair balance as between Equitable investors and tax-payers.
45. Post-1 September 1992 WPAs are to be compensated for 100% of their past and future losses, compared with the average 21% payable to others. As a matter of public law, where distinctions are made between groups who are similarly placed, those distinctions must have a rational basis. The decision-maker must ensure that there are "no favourites and no sacrificial victims": *R v Inland Revenue Commissioners, ex parte National Federation of Self-Employed & Small Businesses Ltd.* [1982] A.C. 617 at 651. Moreover, the payment of compensation to policyholders for their losses falls within the ambit of the right to peaceful enjoyment of possessions within the meaning of Article 1 of First Protocol to the European Convention on Human Rights (the Convention). A difference of treatment as between different classes of policyholders - a distinction made according to the type of property they hold - will be justified under Article 14 of the Convention only if it can be shown that the distinction pursues a legitimate aim and the distinction is proportionate to that aim.
46. The justification is set out in box 2.7 of the Spending Review:
- When affordability is taken into consideration, it is important that the position of those who have been hardest hit by their losses is recognised. Policyholders with With Profits Annuities (WPAs) were particularly vulnerable to reductions in the value of their policies because they were unable to move their funds elsewhere, or to mitigate the impact of their losses through employment. They are also generally the eldest policy holders.
- In light of these factors, the Government will cover the cost of the total relative loss suffered by WPAs, estimated at £620 million.
47. It is undoubtedly true that WPAs were unable to move their funds elsewhere. However, the Ombudsman found that as a result of maladministration, other classes of policyholder were entirely unaware of the weakness of Equitable Life until they had incurred losses which they could not recover, even though they might have been able to mitigate future losses. The single most important consequence of the maladministration which the Ombudsman found was that the regulators allowed the Society to conceal its weakness and attract £20 billion of new premiums throughout the 1990s. The truth about Equitable Life's finances was not revealed until July 2001, when policy values were summarily cut by 16% or £4.9 billion. Accordingly, the distinction between WPAs and others is not rationally justified.
48. Moreover, the degree of priority given to WPAs is disproportionate. Post-1 September 1992 WPAs are being compensated for 100% of their loss, including future losses, whereas all other classes are receiving only around 21% on average. Treating WPAs five times as favourably is disproportionate to the aim in view: while non-WPA investors could move their funds, the circumstances of many were equally compelling to those of WPAs, and the size of the differential

cannot be justified. By determining that non-WPAs should suffer the whole of the abatement for affordability, the Government is requiring them to bear an unfair burden in the public spending round.

49. In considering this aspect of the matter, regard should also be had to the fact that the Government had originally promised that the design of the scheme which was fair as between different groups of policyholders, and the according of priority among groups, were matters on which the independent Commission was to advise after hearing representations. Instead, the Treasury has decided to favour WPAs to this extent without hearing representations or waiting for advice. We shall have more to say on this below.

#### **Exclusion of WPAs who invested before September 1992**

50. The Treasury has only agreed to compensate WPAs who took out their annuity contracts after 1 September 1992. Whether on grounds of rationality or under the Convention, the exclusion of pre-September 1992 WPAs cannot be justified.
51. The Government has accepted all of the Ombudsman's ten findings of maladministration and the consequent findings of injustice. Those findings affect the annuity level of the pre-1 September 1992 WPAs in exactly the same way as the annuity level of the post-1 September 1992 WPAs.
52. Sir John Chadwick said, and the Ombudsman has confirmed, that it was not her intention "... to exclude elderly (i.e. pre-1992) annuitants from compensation". (Sir John's Advice to Government, Section 6.21). Indeed, the Ombudsman's letter to Sir John recommended that all WPAs be compensated by saying "... my recommendation for redress covered all those who suffered relative loss" (Ombudsman's letter of the 20 August 2009 in submission to Sir John, Supplementary Material II-33 and IV-39); and the pre-1 September 1992 WPAs are suffering relative loss on a continuing basis (even if credit is taken for any over-bonussing in the years prior to 2000).
53. The Ombudsman has made clear that she intended that such investors should be included: see Appendix to Ann Abrahams letter explaining to Sir John Chadwick 27 November 2009 (Sir John Chadwick's Supplementary Material part IV, 54 and 55 under the heading "Other matters: the meaning of lost opportunities"):

It is true that those annuitants had no freedom in relation to their with-profits annuity with Equitable Life. However, they were still denied the opportunity to take all the other financial decisions they needed to make, including mitigating actions in relation to their other forms of income and assets or other lifestyle choices, in full knowledge of the precarious financial position of Equitable Life and the risks to the continued value of their annuity income which arose because of that precarious position.

The second reason why there should be no obstacle to those annuitants being included within the scope of the scheme is the finding I made in paragraphs 169 - 189 of Chapter 12 (at pages 353 - 355 of Part 1 of my

report) in relation to the cuts in policy values and annuity payments made by Equitable Life from July 2001.

There I found that, while not exclusively attributable to that maladministration, regulatory maladministration 'was one among many contributory factors to those losses'. In other words, trapped annuitants suffered losses which were caused in part by regulatory failure and for which I recommend that a remedy should be forthcoming.

The Government in its response to my report did not reject that finding nor provide any commentary on it that would constitute reasons for any such rejection. Therefore, I would respectfully suggest that accordingly you are required to take that finding into account when undertaking your work.

54. For his part, Sir John Chadwick could find no rational basis for their exclusion: Sir John Chadwick's Advice to Government, Section 6.21:

I had found it impossible to identify any rational basis on which the Ombudsman could have intended to exclude from her recommended scheme elderly annuitants who had taken out WPA policies before 1 July 1991.

55. The evidence which the Financial Secretary gave to PASC on this point is confusing. He said:

In terms of the third point about people [who] invested up until July 1991, there are two points here. I think that Sir John, in his calculation of internal relative loss, does take into account those people who have been investors up until that point. I believe that is the basis of which there are a number of criticisms. Secondly, the Ombudsman's Report does cover a period from 1991 onwards, and the basis of the compensation should be those people who had invested in that time scale; so the premiums of anyone who invested prior to 1991 and who made premium payments post 1992 would fall under the calculation of relative loss. Of course those people who invested prior to 1991--and it is accepted that Equitable Life did over-bonus in that early period--would have probably done quite well from the strategy Equitable Life followed in that period.

56. We would be grateful if you could clarify what the Financial Secretary meant in this passage.

57. In a Written Answer given on 9 November 2010, the Financial Secretary said simply that

With Profits Annuitants (WPAs) who took out policies before 1 September 1992 did so before any maladministration could have affected their decisions, so therefore have not been included in the Government's proposed payment scheme.

58. The Financial Secretary also sought to explain the exclusion of this group in his letter to Members of Parliament dated 15 November 2010. Having repeated the explanation set out above, he continued:

However, I do recognise that this group of policyholders found themselves locked into a poorly-regulated Equitable Life and they too were affected by the maladministration that occurred. Sir John Chadwick and actuaries at Towers Watson looked at the impact this had on them by calculating what this group **would have received from**

**Equitable Life** had there been no maladministration. They concluded that this group of policyholders **received more income from Equitable Life than they would have done if it had been properly regulated**, even taking into account the policy value cuts in 2003. That is because Equitable Life paid out more to them in the early years than it would have if there had been no maladministration. Even though it paid out less than it should have in later years, the former outweighs the latter. (emphasis added)

59. The Government accepts that these policyholders, like post-1 September 1992 investors, have been trapped in the Equitable Life and that they have been affected by the maladministration that occurred. They have suffered substantial relative loss as a consequence of maladministration, particularly in the years since 2001, and this loss is continuing. Its rationale for exclusion of this group appears to be based on the advice of Sir John Chadwick and Towers Watson's consequent calculations of what he called Internal Relative Loss, i.e. "loss measured by reference to the return which a policy would have received from the investment which he did make in Equitable Life, if the Society had been regulated without maladministration" (see 1.42 and Part 6 of Sir John's Advice). The Government has said that it has rejected Sir John's alternative approach to the assessment of relative loss in favour of the Ombudsman's approach, i.e. the difference between what policyholders actually received from their policies and what they would have received elsewhere. It is not clear why the Government has sought to adopt a different approach for this group and to depend on Sir John Chadwick's highly questionable paradigm of reconstructed Equitable Life.
60. The Financial Secretary sought to make good the rationale for excluding this group of investors in the debate on 10 November. He indicated that Sir John Chadwick and Towers Watson had concluded that because of over-bonusing in the 1980s and early 1990s, pre-1 September 1992 WPAs received more from Equitable Life as a result of maladministration than they would have done had it been properly regulated. He sought to illustrate the point with the following example, provided by Towers Watson:
1. The with-profits annuitant purchased a policy in 1989 and gained through that purchase an income of £7,200.
  2. After 4 years, i.e. by 1993 the policyholder would have been receiving an annuity of approximately £10,000 per annum, as against £9,500 a year if there had been no over-bonusing. By 2002 the policyholder "was receiving £17,000 per annum" as against £15,800 without over-bonusing.
  3. In 2003, Equitable Life cut the rate of annuity payments to its with-profits policyholders by "about 20%", but this would have been 18% without maladministration. In the example, it appears to have been about 24%.
  4. After the 2003 cuts, the policyholder was receiving £12,900 per year from Equitable Life, but it would have been £12,300 had there been no maladministration.

Upon analysis, this example is extremely misleading.

Investors choose an anticipated bonus rate (ABR) when taking out a with-profits annuity. Annuities with higher ABRs pay higher initial incomes, but the higher the starting income, the less chance there is that it will increase in future. The Financial Secretary's illustration can only have been made on the basis of a 0% anticipated bonus rate (ABR), so that the totality of declared bonuses would have been added to the policyholder's fund, thereby increasing the income in subsequent years. However, a 0% ABR is wholly untypical, accounting for only 2.5% of Equitable Life's WPA business. The example is calculated to convey an impression of sharply increasing and substantial continuing annual income, even after the cuts in 2003.

61. This example bears no relation to the actual experience of WPAs. Had the investor in Mr Hoban's quoted example elected a 6.5% ABR (which was the level most commonly recommended and chosen at the time) his position would have been as follows:

- a. initial annuity £11,000;
- b. by 2002, annuity of £11,400;
- c. in 2003, he sustained a 28% cut;
- d. after the cut, an annuity of £8,200;

In this example, income declined to £5,800 in 2007.

62. This example has been plotted on a graph (enclosed) against the example given by the Financial Secretary on 10 November 2010. What is immediately apparent is that the typical investor is sustaining very substantial continuing losses. The enclosed table shows that in the Financial Secretary's example, the total earnings from 1989 to 2007 were £230,600 while in the typical comparator case they were £200,800 - exaggerating the total income in the example compared with the typical real investor by £30,000.

63. The Programme for Government promised transparency. However, the Financial Secretary did not disclose to the House of Commons any of the information which formed the basis of this example which, as can be seen, is materially misleading. We assume that this, untypical, case study is not the only one that Towers Watson provided. We shall be grateful if you will now disclose the full material which supports the Treasury's conclusion that pre-1 September 1992 WPAs did not suffer any relative loss. In particular, we ask that you disclose information which supports the Treasury's conclusion that the investments of pre-1 September 1992 WPAs fared more favourably than those who took out their policies on or after that date. Specifically we ask you to publish the comparison between a:

- a. A 65-year old man who took out an annuity with a 6.5% ABR In 1989, through to 2009; with

- b. A 65-year old man who took out an annuity with a 6.5% ABR in 1993, through to 2009.

In each case, the comparator should be an alternative, external, provider, in accordance with the Ombudsman's methodology. We anticipate that they will disclose virtually no difference between the two examples, with flat levels of income through the first decade followed by equal devastating falls since 2002 for both Equitable Life annuitants as against rises for comparator companies.

64. The effect of this exclusion will fall most heavily on the oldest and most frail investors, who are in their 80s and 90s. Those worst affected are the WPAs who took out an annuity policy from 1 January 1987 (when the product was launched). They have suffered very substantially from the effects of maladministration. The terms of reference of the independent Commission enjoined it to "have regard to<sup>2</sup> the impact of their recommendations on the basis of gender, age, ethnicity and disability". But the Government has now largely removed this element of the scheme design from the Commission by removing the WPAs from the Commission's remit retrospectively. We assume, but kindly confirm, that the Government sought to respect this injunction in reaching its own decision to discriminate against pre-1 September 1992 WPAs. However, we cannot see how the conclusion reached can be consistent with an intention to avoid age discrimination.
65. At present, in agreement with the Ombudsman and Sir John Chadwick, we cannot see how this distinction can be regarded as implementing the Ombudsman's central recommendation. Not only are this group excluded from compensation for losses to date but they are also excluded from compensation for any future losses. This group of about 10,000 pensioners have seen their pensions reduced by more than half in the last six years. Exclusion of WPAs who had invested before 1 September 1992 does not fulfil the Coalition's promise to provide fair payments for these investors' relative loss incurred as a result of regulatory failure.

#### **Failure of consultation and by-passing the independent Commission**

66. The Government has made the decision to favour post-1 September 1992 WPAs. The Treasury has also made other decisions about allocations, such as exclusion of pre-1993 investors.
67. These were decisions which the Government had said would be made following recommendations by the Commission, after consultation.
68. The Treasury has failed to keep its promise to establish a payment scheme which would be independently designed. It has also frustrated the legitimate expectation of consultation created by the statements which the Financial Secretary made when the Commission was established.

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<sup>2</sup> The revised terms of reference have changed this to an obligation to "consider" the impact.

69. The Commission's original terms of reference made clear that

The role of the Independent Commission is to:

- Recommend how best to fairly allocate funds provided for the Equitable Life Payments Scheme as part of the Autumn 2010 Spending Review to those persons found to have suffered relative losses as a result of accepted Government maladministration.
- Advise on any groups/classes of persons that should be paid as a priority.

The revised term of reference [27 October, 2010] qualified its remit by adding the words "excepting With-Profit Annuitants (WPAs) and their estates" to the first bullet point. In its original terms of reference, the Commission was to "have regard to, but need not be bound by findings on disproportionate impact carried out by Sir John Chadwick", and it was to "meet with representatives of interested parties as appropriate."

70. The Commission was also to receive representations. On 26 May 2010 the Financial Secretary told the House of Commons that:

Today, I am confirming this Government's pledge to making fair and transparent payment to Equitable Life policyholders, through an independently designed payment scheme, for their relative loss as a result of regulatory failure. We will set up an independent commission to determine the design of the scheme.

71. On 22 July 2010, in answer to a question, Mr Hoban said:

I want EMAG and others to take part in the debate about the scheme, and I am very happy for them to make representations to the independent commission that will help to draw up the detail of the scheme.

72. In its letter to us of 11 August 2010, the Treasury said:

Should there be insufficient funds available to meet all losses, it would make sense for the Commission, in deciding how the available funds should be allocated between policyholders, to have regard to Sir John's advice as to which policyholders have suffered most as well as to any additional information the Commission requests from its actuarial advisers.

We had also asked to whom representations should be made. The same letter answered our question as follows:

As I hope is clear from my answer above, please address representations as to the final loss figure and the amount available for the payment scheme to the Financial Secretary. Please address representations as to allocation between policyholders to the Commission.

73. In his evidence to PASC on 14 October 2010, Mr Hoban said (in response to a question about possible exclusion of the 40% of policyholders whose losses were between £1 and £1,000):

It is a matter for the independent payments commission to decide. One of the commitments we gave was that the design of the scheme would be independent of the Treasury; the Treasury would determine compensation as part of the spending round, but we would pass over to an independent commission the design of the scheme. That was

something EMAG and we were keen to do, and the independent commission has already met to start work on this.

74. Thus the Commission was to advise on allocation, and priorities, after receiving representations from interested parties.
75. However, the Written Ministerial Statement made by the Financial Secretary on 20 October 2010 says:
- The Independent Commission on Equitable Life Payments will advise on the allocation of funding to policyholders other than WPAs. I have also asked the Independent Commission to advise me on the prioritisation of payments to policyholders within this group, to ensure that those whose need is greatest are paid first. (Emphasis added)
76. The curtailment of the Commission's remit is made clear when one compares the original terms of reference with the revised version, issued on 27 October 2010. We enclose a comparison document.
77. The Treasury has therefore pre-empted, and undermined, the role of the Commission by removing from its remit the possibility of advising on the distribution - both priority and timing - of just under half of the total sum to be made available to the scheme. In doing so, it has broken its commitment that the scheme should be independently designed. It has also frustrated the promise of consultation which was made in the debate on 22 July 2010, in correspondence with us and in evidence to PASC.
78. Based on Government promises between May and October 2010, our clients reasonably expected the Treasury, having decided upon an amount of compensation, to leave the Commission to recommend distribution. EMAG therefore deliberately decided not to address the Commission in writing on allocation until it knew the size of the compensation fund.
79. EMAG would have made representations regarding the division of this pot between particular groups of policyholders. As more than half its members are WPAs, EMAG would have advanced their case robustly and even-handedly, certainly involving prioritising their payment. The Government's decision now puts beyond the Commission's reach the disposition of almost half the fund, and questions of relative priority over that fund. Those are therefore matters over which our clients can have no influence.

**Action to be taken**

80. For the reasons set out in this letter, we consider that the Government's decisions are unlawful.
- a. We invite you to quantify relative loss properly in the manner set out in this letter.
  - b. Such quantification must inevitably lead the Government to re-assess whether the funds which have been made available for the Equitable Life payments scheme strikes a fair balance between Equitable Life policyholders on the one hand and tax-payers on the other. In particular, the Government will need to re-assess the fairness of the level of compensation which it has decided should be paid to non-WPAs.

- c. We also invite you to agree in principle that the benefit of the scheme should be extended equally to pre-1 September 1992 WPAs.
- d. In addition, we invite you to revise the terms of reference of the independent Commission so as to empower it to consider the allocation of the whole of the sum which the Government decides to make available to compensate policyholders for their relative loss.

#### Documents and information required

81. The Coalition's Programme for Government promised that any payments scheme would be transparent. The decisions which have been made do not meet this criterion. In the interests of transparency, kindly let us have:
  - a. The information on the basis of which the Government concluded that it was impossible to quantify the losses of those investing in Equitable Life before 1 September 1992 (in the case of WPAs) or the end of 1992, in the case of other policyholders;
  - b. Details of the inquiries which the Government made before reaching this conclusion;
  - c. The assessment which the Government conducted of the impact of its decisions on the basis of gender, age, ethnicity and disability;
  - d. Communications which the Government had with Sir John Chadwick about the feasibility of revising his terms of reference to embrace all the Ombudsman's findings of maladministration and injustice;
  - e. Material which the Government took into account, other than that from Sir John Chadwick and Towers Watson, in reaching its decisions;
  - f. Additional models or other information provided to the Government to enable it to reach its conclusions; in particular, material forming the basis of the conclusion that pre-1 September 1992 WPAs had not lost anything (referred to in paragraph 63 above).
82. We also require clarification of part of the statement made by the Chancellor of the Exchequer to the House of Commons on 20 October 2010. In the course of that statement he said, "We will also help those **across the United Kingdom** who have lost money as a result of the collapse of Equitable Life." The previous Government intended that any scheme of compensation would be extended to investors in other parts of the European Union, in particular those in Ireland and Germany, whose regulators relied on the assessments of the UK regulators under reciprocal "passporting" arrangements. This Government has not made any public statement which is inconsistent with the position of its predecessor. Please confirm that the benefit of any scheme of compensation will be extended to investors who are resident outside the United Kingdom whose regulators relied on the assessments made, and therefore the assurances given to them,

by the UK prudential regulators. If the Government intends to exclude non-UK residents from the scheme, kindly let us know the basis on which this decision has been reached, as no reasons have been given.

**Time for reply**

83. We look forward to receiving your reply within 14 days of the date of this letter, i.e. by 9 December. This matter is being dealt with by Stephen Grosz at this office.

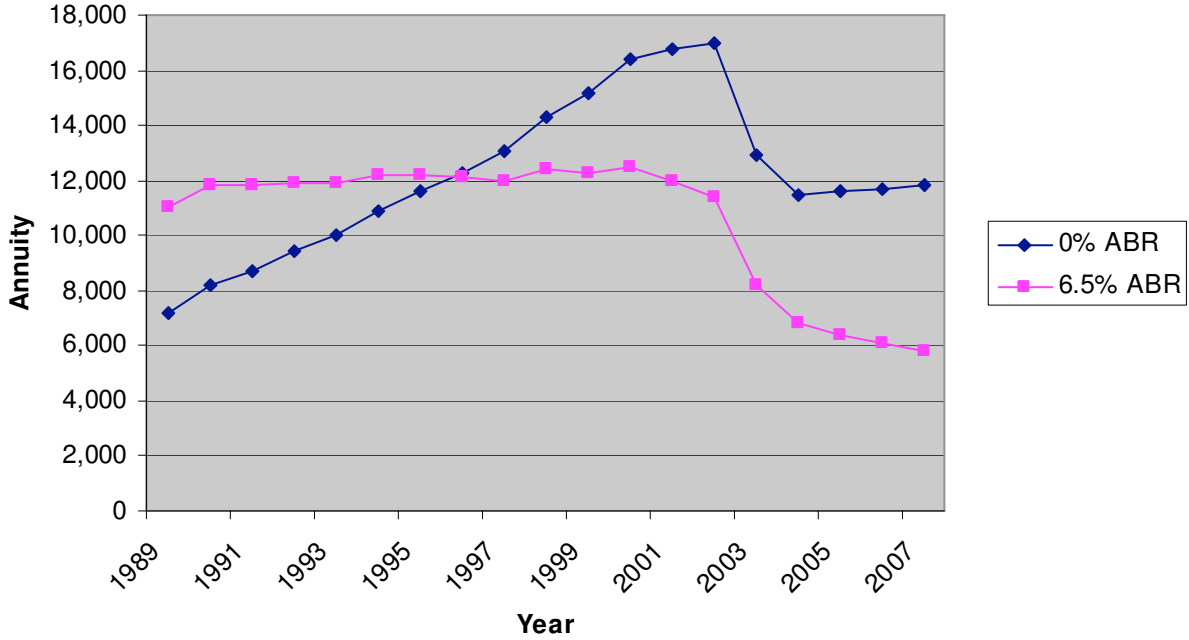
Yours faithfully

*Bindmans LLP*

**BINDMANS LLP**

Encs.

**WPA: 0% ABR vs 6.5% ABR**



**Single-life WPAs for Male, aged 65, taken out in July 1989 for same purchase price.**

Date of first payment in year	0% ABR	6.5% ABR
1-Aug-89	7,200	11,000
1-Aug-90	8,200	11,800
1-Aug-91	8,700	11,800
1-Aug-92	9,400	11,900
1-Aug-93	10,000	11,900
1-Aug-94	10,900	12,200
1-Aug-95	11,600	12,200
1-Aug-96	12,300	12,100
1-Aug-97	13,100	12,000
1-Aug-98	14,300	12,400
1-Aug-99	15,200	12,300
1-Aug-00	16,400	12,500
1-Aug-01	16,800	12,000
1-Aug-02	17,000	11,400
1-Aug-03	12,900	8,200
1-Aug-04	11,500	6,800
1-Aug-05	11,600	6,400
1-Aug-06	11,700	6,100
1-Aug-07	11,800	5,800

Amounts rounded

# Independent Commission on Equitable Life Payments

**TERMS OF REFERENCE**  
UPDATED – OCTOBER 2010

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Independent¶  
Commission¶  
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## Role

1. The role of the Independent Commission is to:

- Recommend how best to fairly allocate funds provided for the Equitable Life Payments Scheme in the first three years of the Spending Review to those persons found to have suffered relative losses as a result of accepted Government maladministration, excepting With Profits Annuitants (WPAs) and their estates.
- Advise on any groups/classes of persons that should be paid as a priority with regard to the timing of payments, again excepting WPAs and their estates.

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In providing its advice, the Commission shall have regard to the practicalities of delivering the payment scheme.

3. The Commission may review additional evidence should this be necessary to fulfil the terms of reference, but having regard to the need to keep to the time constraints set out in paragraph 7.

Deleted: <#>The Commission will have regard to the work undertaken by Sir John Chadwick on the methodology for calculating relative loss and base its allocation to policyholders on the relative loss figures provided to HM Treasury by Towers Watson.¶

Subject to the following Ministerial requirements, the Commission is free to operate as it sees fit. These requirements are:

- £775 million funding is available for payments to non-WPAs as part of the Spending Review. The proposed allocation made by the Commission must be within this amount.
- Payments must fit within the spending envelope supplied by the Government to aid the affordability and operational delivery of this scheme.
- The Commission will base the allocation on methodology endorsed by the Government at the Spending Review.
- Means testing will not be used as a method to decide how payments are divided.
- The estates of deceased policyholders must be considered as part of the scheme in the same manner as living policyholders.
- The Commission will not consider tax implications for the purposes of its work.
- The Commission will not consider the application of interest to losses or payments for the purposes of its work.

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Objectives¶

## Objectives

5. The primary aim of the Commission is to recommend how best to fairly allocate funds provided for the Equitable Life Payments Scheme to those persons found to have suffered relative losses as a result of accepted Government maladministration, excepting WPAs and their estates.
6. The Commission should provide regular updates as it carries out its work in order to aid transparency and ensure that the public is kept informed of its proceedings, and to enable work on the establishment of the payment scheme to progress in parallel as far as possible.

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The Commission should provide its final advice to the Government by the end of January 2011.

## Assumptions and Evidence

- 8 The Government has accepted £4.3bn as the relative loss figure. This figure encompasses the Parliamentary Ombudsman's findings of maladministration, all of which the Government accepts.
9. The Commission will accept the methodology used to arrive at this figure, as endorsed by HM Treasury at the Spending Review, as the basis for their calculations.
10. In the interests of speed and of the public purse, the Commission should ensure that it does not unnecessarily replicate existing analysis determining relative loss.
11. It will have regard to, but need not be bound by, findings on disproportionate impact set out by Sir John Chadwick.
12. The Commission will meet with representatives of interested parties as appropriate.
13. The Commission will consider the impact of their recommendations on the basis of gender, age, ethnicity and disability.

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## Spending Envelope and Timing of Payments

14. The Government will provide the Commission with a spending envelope of £775million. The Commission should have regard to the profiling of these payments over the three year period (approximately 50-55% in the first year, 25-30% on the second and 15-20% in the third.)
15. The Commission can make a recommendation on prioritising the timing of payments to particular groups of policyholders.

### **Structure/ Composition**

16. The Commission will comprise of three people, one of whom will act as Chair.

### **Interaction with Scheme Design Consultants and Actuarial Support**

17. The Commission shall have at its disposal actuarial support to calculate the permutations of various scenarios for allocating payments to individual policyholders and members or trustees of group schemes. This actuarial support will consist solely of responding to the Commission's directions,

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18. The Commission shall also have access to advice provided to HM Treasury on scheme design to help understand the effect that their advice will have on the deliverability of the scheme. However, the Commission will not advise on the administrative and operational mechanics of delivering payments to policyholders, or the appeals process.