

**A SECOND SUBMISSION TO THE INQUIRY  
CONDUCTED BY LORD PENROSE  
INTO THE LESSONS THAT CAN BE  
LEARNT FROM THE EQUITABLE DEBACLE**

**A CASE STUDY IN SERIAL REGULATORY FAILURE  
BY THE GOVERNMENT AND ITS AGENT,  
THE FINANCIAL SERVICES AUTHORITY**

**THE EQUITABLE MEMBERS ACTION GROUP (EMAG)  
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<b>CONTENTS</b>	<b>PAGE NO.</b>
ABBREVIATIONS	3
1. SUMMARY – THE CASE FOR SERIAL REGULATORY FAILURE FROM THE LATE 1980s/EARLY 1990s	4
2. INTRODUCTION	11
3. ALLOWING THE EQUITABLE TO OVER-DECLARE TERMINAL BONUSES	18
4. ALLOWING THE EQUITABLE TO EXPAND WHEN IT WAS FINANCIALLY WEAK	21
5. DELAYING ADDRESSING THE EQUITABLE’S GAO ISSUE AND THE INEFFECTIVE SOLUTION	29
6. ALLOWING THE EQUITABLE TO REMAIN OPEN AFTER THE HOUSE OF LORDS DECISION	41
7. THE FSA’S FAILURE TO TAKE ACTION TO MITIGATE THE CONSEQUENCES OF THE HL DECISION FOR POLICYHOLDERS WITHOUT GAOS	48
8. FAILURE TO ENSURE THAT POLICYHOLDERS AND PROSPECTIVE POLICYHOLDERS WERE PROPERLY INFORMED ABOUT THE EQUITABLE’S FINANCIAL CIRCUMSTANCES	52
9. THE COMPLETE FAILURE OF CONDUCT OF BUSINESS REGULATION	56
10. THE ROOTS OF REGULATORY FAILURE	59
Annex THE LEGAL FRAMEWORK OF REGULATION	62

## ABBREVIATIONS

Baird or the Baird report – the report of the Financial Services Authority on the Review of the regulation of The Equitable Life Assurance Society from 1 January 1999 to 8 December 2000

DTI – Department of Trade and Industry

EMAG - Equitable Members Action Group

FSA – Financial Services Authority

GAD - Government Actuary's Department

GAO – guaranteed annuity option

GIR - guaranteed interest rate (which equalled 3.5% in most with-profits policies issued up until 1996)

HL – House of Lords

IBD - Investment Business Division of the FSA

ID - Insurance Directorate of the DTI and then the Treasury

IFSD - Insurance and Friendly Societies Division of the FSA

ISC - Insurance Supervisory Committee

PIA – Personal Investment Authority

RMM - Required minimum margin of solvency, whose amount was calculated in accordance with the Insurance Company Regulations 1994. The requirements are now set in the FSA's Interim prudential Sourcebook for Insurers.

1. SUMMARY – THE CASE FOR SYSTEMIC REGULATORY FAILURE FROM THE LATE 1980s/EARLY 1990s

1.1 The tone of the three Acts that have provided the bases of regulation of life companies – The Insurance Companies Act 1982, The Financial Services Act 1986, and the Financial Services and Markets Act 2000 - is paternalistic. The “authorities” have regulation powers which they can exercise vis-à-vis companies providing insurance business (and for which they are not liable in law). But the Acts neither provide the consumers of such services with statutory rights vis-à-vis the providers, nor do they provide consumers with redress against the “authorities” when the latter are guilty of regulatory failure, however grave the fault of the authority. While we regard this style as inappropriate in this day and age, and it is in marked contrast to the style of legislation in the US and Australia which provide consumers with direct rights, it should be regarded as putting a strong onus on the authorities to act vigorously on behalf of consumers, especially as the latter are liable to be lulled into a false sense of security because life companies have been described as being “regulated” by the government. **As we will show the regulatory authorities have completely failed the consumers of The Equitable.**

1.2 Based on the report “The Equitable Life Assurance Society - The With-Profits Fund 1993-2000” we commissioned from accountants Burgess Hodgson, on the “Report of the Financial Services Authority on the Review of the regulation of The Equitable Life Assurance Society from 1 January 1999 to 8 December 2000”, and on other sources we have identified the following seven areas where the responsible government departments and its agent, the Financial Services Authority, failed the members of The Equitable.

- (i) To allow The Equitable to declare such high terminal bonuses that reported policy values were generally in excess of its total assets throughout the 1990s. At least from 1990, The Equitable persistently declared total bonuses in excess of asset values. The regulator<sup>1</sup> was aware of the practice from at least 1997, but this “did not necessarily cause any concern”. It should have done so because the consequences were that policyholders who took contracted exits in the period 1994 to 15 July 2000<sup>2</sup> either took out more than their asset share or, if they took an annuity from The Equitable, incurred a liability in excess of their asset share. *This weakened the fund. We estimate that those who took contracted exits merely over the period 1 January – 15 July 2001 took out £200m more than their asset share.* The excess was at the expense of the policyholders who remained and of those who joined; their “policyholders’ reasonable expectations” were undermined since they did not expect to cross-subsidise other policyholders.

<sup>1</sup> We use the term “regulator” in the summary as a generic term to embrace the Insurance Directorate of the Department of Trade and Industry and then of The Treasury; the Government Actuary’s Department; and the Insurance and Friendly Societies Division and the Investment Business Division of the Financial Services Authority.

<sup>2</sup> Also, from March 1997, when the market value adjustment was reduced to zero, until 8 December 2000, when the market value adjustment was increased to 10%, policyholders who took uncontracted exits took more than their asset share.

**The casual attitude of the regulator allowed The Equitable to operate something akin to a Ponzi fund to encourage new business; exposed new investors to risks which were entirely inappropriate for an allegedly cautious with-profits fund; and contributed significantly to the savage cuts in policy values in 2001 and 2002.**

- (ii) To allow The Equitable to expand fivefold in nominal asset value over the 1990s even though the regulator knew that it was financially very weak. On numerous occasions from at least 1997 until the end of 2000 the regulator expressed concern about The Equitable's ability to reserve adequately and concern about its solvency. At the end of 1998 the regulator mentioned the possibility of "regulatory action" which included the possibility of closing The Equitable to new business, and instructing The Equitable that "in the absence of a robust reinsurance agreement...it [would not be] prudent for Equitable Life to declare any bonus for 1998".

In mid March 1999 the regulator "remained concerned about the financial viability of The Equitable in the longer term", and in August it was seen as a "high financial risk". In the event the regulator was satisfied by allowing The Equitable to use financial engineering to boost its solvency margin. An unsigned (so called) "reinsurance contract" (which in reality was merely a mechanism for rescheduling the timing of liabilities) was enough to satisfy the regulator's requirement for "robust reinsurance". The regulator advised "a low profile approach" in handling The Equitable.

During all this period the regulator did not notice:-

- the burden on The Equitable's with-profits fund from its non-profit business. (We suggest the Inquiry examine whether these classes of business had matched investments, or appropriate reserves were made to cover any mismatching and the mortality risk)
- the effect of a quasi Zillmerising<sup>3</sup> arrangement, which was estimated by The Equitable's auditors to reduce liabilities by "just under £1bn"

Eventually, on 24 November 2000, (which in the circumstances was a disgraceful delay), with The Equitable floundering towards closure and chaos, the regulator concluded that "*at first sight the solvency position looked reasonable, but the available assets of £3,861m to cover the required minimum margin of £1,114m included a future profits implicit item of £925m, disregarded the liability to repay a subordinated loan of £346m and benefited from a reduction of almost £1.1bn in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511m, "a less satisfactory picture for this large fund".* Note that although subordinated loans and reinsurance contracts are allowed under an EU Directive, the Member State regulatory authority is empowered to agree the value put upon them in calculating the solvency margin. The values were absurdly high.

**Notwithstanding its obvious financial weakness, the regulator acquiesced in The Equitable's policy of growing rapidly, which increased the strain on its solvency.**

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<sup>3</sup> See paragraphs 4.18 and A7 together with related footnotes for an explanation.

- (iii) To delay in addressing The Equitable's guaranteed annuity option (GAO) problem. The issue of provisioning for guarantees was analysed in the actuarial literature in the mid-1980s, and an Actuarial Guidance Note dated 1983 advised actuaries to reserve for maturity guarantees in unit linked contracts. It was but a small step from these policies to GAOs. *The Equitable, with its very low free asset ratio and negligible orphan estate, was singularly exposed to the risk of GAOs coming into the money and possibly imposing costs on policyholders who did not have GAOs. The regulator could – and should - have concluded that action should have been taken possibly to stop it taking on new personal pension plan business which did not have GAOs; possibly for the guarantees to be written out of existing policies; and at very least to commence reserving for the guarantees, and charging for them either from the premiums paid or by reducing the bonuses paid to policyholders with GAOs.*

We consider this failure to have been a foundation of subsequent problems, and a very serious regulatory failure that contravened the clearly implied purpose of s.45 of the Insurance Companies Act 1982 which empowers the regulator to “require a company to take such action as appears to him appropriate...to fulfil the reasonable expectations of policyholders or potential policyholders”. The subsequent inaction in 1996 of allowing The Equitable to issue policies without a guaranteed interest return (GIR) was a similar failure.

The Equitable first recognised that GAOs had become a problem at the end of 1993, but the regulator did not engage The Equitable seriously about GAOs until September 1998, five years after the problem had emerged<sup>4</sup>. Then (as noted above) it allowed The Equitable to satisfy its solvency margin with financial engineering (which, better late than never, the European Commission and the FSA will be prohibiting). It was not until 24 November 2000 that the regulator finally submitted its detailed scrutiny report on The Equitable's 1999 regulatory returns, and expressed various concerns about the financial strength of the fund including the reinsurance treaty, which “is not wholly satisfactory from a regulatory perspective as it relies on regulatory arbitrage to achieve the desired result, and would not be available in the event of insolvency”.

**The regulator's failure in the late 1980s/early 1990s to force The Equitable to deal with the risks it had assumed, and its subsequent dilatory performance in dealing with reserving for the GAOs, was a foundation of The Equitable's eventual financial difficulties.**

- (iv) To allow The Equitable to remain open to sell with-profits policies after the House of Lords decision. Just before the decision, under pressure from The Equitable, the regulator stated that it would not “rush to take remedial action”, a policy that was in keeping with its well established tradition of never taking action that might embarrass The Equitable. Howard Davies, the chairman of the Financial Services Authority (FSA), subsequently justified allowing The Equitable to remain open on the grounds that:-

“we thought that it was likely to produce the best outcome for policyholders, in that closing it to new business at the time would have significantly reduced the value of the company and would have significantly reduced the likelihood of a successful sale, which filled the hole”.

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<sup>4</sup> The Treasury Committee, Tenth Report, Equitable Life and the Life Assurance Industry: An Interim Report, Volume I, 27 March 2001, The Stationery Office Limited, observed “It is unclear to us why the issue of GAR liabilities and reserving was not considered by the prudential regulator at least by 1993, rather than only in 1998. We believe that the current inquiries should pursue this closely” (paragraph 12).

Prior to making this decision the FSA did not appear to understand fully the financial weakness of The Equitable (as noted above the scrutiny report for 1999 was not completed until 24 November 2000), nor the significance of the fact that policyholders with GAOs could top them up and so represented an unknown liability. Nor did the FSA analyse the consequences of failing to find a buyer.

The regulator was not only allowing prospective policyholders to join a fund that was weak before the House of Lords decision and was further weakened by the decision, it was furthermore undermining their reasonable expectations. People were essentially being allowed to invest their money on the implicit prospectus that if The Equitable can find a buyer who will resolve the consequences of past over-bonusing, then investors may have reasonable expectations. If not, they are in a mess. Although prospective bidders for The Equitable quickly realised the true magnitude of the financial difficulties, it appeared to take some time for the penny to drop with the FSA<sup>5</sup>.

**We consider that the consequences of allowing The Equitable to remain open – which resulted in thousands of people investing in The Equitable and losing money, and more legal dispute - was a major regulatory failure. It brings out in extreme form the inherent conflict in the FSA’s objectives between preserving market confidence, which will be its overriding priority and will generally prevail – and definitely did in this case – and protecting consumers when it might cause embarrassment. *We recommend that responsibility for conduct of business regulation is transferred from the FSA and set up as an independent agency.***

- (v) The FSA’s failure to take action to mitigate the consequences of the HL decision for policyholders without GAOs

**In view of the obviously flawed nature of the House of Lords decision, we consider that the FSA failed in not considering the possibility of legal means of mitigating the consequences of the decision for policyholders without GAOs. Instead it acquiesced when The Equitable reduced policy values in a manner which did not attempt to redress the harm to such policyholders, and recommended a compromise agreement which discounted their mis-selling claims. Policyholders without GAOs who left The Equitable before the compromise was agreed, and are now claiming for mis-selling, are likely to do better than those who followed the FSA’s advice on the compromise. In view of its unequivocal active endorsement of the compromise, this should be embarrassing to the FSA since it is supposed to protect the policyholders’ reasonable expectations.**

- (vi) To fail to ensure that policyholders and prospective policyholders were properly informed about The Equitable’s financial circumstances. Although the government has had comprehensive powers for two decades to prescribe both the form of insurance companies’ accounts and their solvency returns, those documents:-

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<sup>5</sup> On 17 November 2000, *three weeks before The Equitable closed for new business*, the regulator commented that “(a) GAR policyholders might seek to top-up their policies as much as possible in order to maximise the value of the GAR; (b) that this was “likely to shift The Equitable Life GAR liability significantly upwards”; and (c) that additional payments made by non-GAR policyholders would be used to subsidise GAR policyholders”. A week later it “raised the question of whether the Society should be continuing to sell non-GAR policies in the same fund as that where the GAR policies reside...”. By this time, well past the eleventh hour, a firm grasp of the obvious was of no benefit to policyholders.

- are not mutually consistent
- the accounts are not complete, namely there is:-
  - \* no statement of how the total value of policies compared with asset values
  - \* no record of a provision of £1.6bn for GAOs in 1998 and 1999
  - \* no explanation of the *significance* of either the subordinated loan of £346m nor of the reinsurance contract
  - \* no summary statement of solvency position
- the solvency return is not comprehensible, including to the regulator who offered as a partial excuse for not picking up The Equitable's GAO issue more quickly that "the presentation of their returns was somewhat obscure"

There was no way in which a (prospective) policyholder who was not a life assurance actuary or an accountant specialising in life assurance – i.e. nearly all policyholders - would have been able to ascertain the financial circumstance of The Equitable. Furthermore, since The Equitable sold exclusively through a direct sales force, there was no source of external informed advice for a (prospective) policyholder to look to.

In line with the Sandler Report, we recommend that there should be a separate with-profits account, a smoothing account; an account for supporting capital; an account for the non-profit business; and accounts for other business activities, which should be accounted for and reported separately in the Annual Report and Accounts. Even now the FSA is proving dilatory at improving life assurance accounting and reporting.

**The inadequate provision of information was a significant failure by the regulator who under the legislation was endowed with a paternalistic role. Not only did it not exercise that role, but also it made no attempt to ensure that policyholders would be able to assess the financial situation of The Equitable for themselves.**

- (vii) The conduct of business regulation was a complete failure to look after policyholders' reasonable expectations.

**Prior to the closure of The Equitable, the FSA did *absolutely* nothing to investigate, let alone protect, policyholders' reasonable expectations. Its performance was nothing short of disgraceful.**

1.3 The Baird Report provides information on regulatory decisions from 1997. We hope that the Inquiry will examine carefully the period after the personal pension plans (without GAOs) were introduced in 1988. *It should have been clear by the early 1990s, when long-term gilt yields and annuity rates were falling, that The Equitable was not capable of withstanding falling interest rates because of its excessive bonuses and onerous guarantees. In view of its weak financial position it was improper for The Equitable to be issuing policies without GAOs. The regulator knew, or should have known what was going on, and taken action such as closing the fund. It did nothing. We hope the Inquiry will investigate and report on this matter.*

1.4 The Equitable has been a special case in three respects. First, it had a stated policy of operating its with-profit fund without an orphan estate, distributing profits to policyholders whose funds provided the resources to generate the profits. Consequently it was financially weak relative to funds that distributed a lower proportion of profits and built an estate. *For this reason it should have attracted closer regulatory scrutiny than other funds, but it clearly did not.* Second, we suggest that the Inquiry investigate whether The Equitable “benefited” from less rigorous regulatory scrutiny for reasons that were extraneous to the regulatory regime. Some possible reasons might be because it:-

- was the fund favoured by many of the “establishment”
- was a mutual that neither had shareholders entitled to 10% of profits, nor incurred the expenses of selling through independent financial advisers, and had low costs. It was perhaps a “business model” for the “stakeholder funds” which the government wished to promote. If a relatively low profile part of the civil service tried to draw public attention to The Equitable’s shortcomings, then it might have been silenced from a greater height

Third, the demise of The Equitable cannot be substantially attributed to the collapse of the stock-market, which hit many other funds over the year 2002 and early 2003. The Equitable’s difficulties preceded this period. Ironically because it was progressively forced out of equities, it was the best performing fund in 2002.

1.5 One possible reason for regulatory failure was a shortage of resources. The staffing level deployed for the prudential regulation of insurance companies appeared to be much lower than that deployed for banking regulation. A second reason was serious shortcomings on the part of the Government Actuary’s Department which:-

- disregarded The Equitable’s practice of declaring total bonuses in excess of asset values
- supinely acquiesced in the policy adopted by The Equitable during the 1990s to grow rapidly
- was aware, but was not concerned, that The Equitable's policy values exceeded its assets
- failed to address the general issue of reserving GAOs in the 1980s
- failed in the late 1980s/early 1990s to force The Equitable to address the potential risks it had taken on, but allowed it to continue writing personal pension policies which had no GAOs. These policyholders were at risk of bearing the costs of policies whose GAOs came into the money on their guaranteed values. In like manner it failed in 1996 to protect policyholders without a GIR

- did not engage The Equitable on the GAO issue until five years after it emerged as a problem
- missed The Equitable's quasi-zillmerising which added nearly £1bn to the solvency margin
- never identified the drain on the with-profits fund from non-profit business
- was dilatory in undertaking its scrutiny analyses
- did not discount the contribution of the virtually valueless reinsurance contract to the solvency margin
- did not appreciate that The Equitable's policies, which incorporated GAOs that could be topped up, constituted a potential time-bomb (which was the major factor making the business unsaleable)
- did nothing to improve the provision of information to policyholders

A third reason was cultural attitude. As the FSA's own review of its regulation of The Equitable observed, "The Review Team's impression of the style of the prudential regulation of the long-term insurance industry inherited by the FSA, when compared with its prudential regulation of the banking industry, is that it is less intrusive and involved than banking regulation".

1.6 The story of the regulation of The Equitable from the mid 1990s until the end of 2000 was one of technical ineptitude coupled with dilatory analysis, bureaucratic inertia, secrecy, and a preference for "a low profile approach" in handling The Equitable. Behind closed doors the regulator exchanged meaningful (and perhaps back-covering minutes) minutes. Although the regulatory authorities may have complied with the letter of the law, they bent over backwards in their judgements to accommodate The Equitable's difficulties and avoid any public exposure – until it was too late. Despite repeated expressions of concern for "policyholders' reasonable expectations" and of concern at the financial weakness of The Equitable, when The Equitable threatened a judicial review the FSA was reluctant to confront it and fight a corner for the benefit of policyholders. Although the regulator had ample powers and huffed and puffed, it was a paper tiger scared to say boo to The Equitable goose. *We note that in the traditional manner of the civil service enjoying safe jobs and indexed linked pensions, no-one in either the current or predecessor to IFSD, IBD, or GAD appears to have been called to account for the disgraceful incompetence displayed in the failures of regulation of The Equitable.* The whole episode has been one of regulatory flabbiness, followed by "retributory" flabbiness.

**1.7 At least over the latter half of the 1990s through 2000, the government as the regulator did nothing – absolutely nothing – for the members of The Equitable. The buck stops with the government, which has been responsible for allowing the destruction of policyholders’ reasonable expectations on a grand scale. The government should compensate the policyholders who did not have GAOs (including with-profits annuitants) and who did not leave The Equitable before 16 July 2001 because their reasonable expectations were undermined by its regulatory incompetence.**

## 2. INTRODUCTION

2.1 The Equitable Members' Action Group (**EMAG**) was founded in September 2000. It currently has 9,000 members, all of whom have paid a subscription. Until the compromise agreement the main objectives of EMAG were "to seek to ensure that policyholders are allowed a fair opportunity to influence the future of the Society" and to provide information to all classes of members to help them judge their positions. Following the compromise EMAG's main aim has been to seek compensation from the government for the regulatory failure of the responsible government departments and agencies.

2.2 The main purpose of this submission is to identify and set out the regulatory failures that have occurred. Until 1998 the Insurance Directorate (**ID**)<sup>6</sup> of the Department of Trade and Industry (**DTI**), with support from the Government Actuary's Department (**GAD**) which is part of the Treasury<sup>7</sup>, was the prudential regulatory authority. On 5 January 1998 responsibility was passed to HM Treasury. From 1 January 1999, through a Service Level Agreement with the Treasury, the Financial Services Authority (**FSA**) has de facto been the prudential regulatory authority through its (then) Insurance and Friendly Societies Division (**IFSD**). On 1 December 2001 the FSA assumed powers in its own right. From July 1994 until 1 June 1998 the Personal Investment Authority (**PIA**) was the conduct of business regulator. On 1 June 1998 the PIA staff were transferred to the employment of the FSA, and in practice the FSA assumed the responsibilities of the PIA, which were undertaken by its Investment Business Division (**IBD**). On 27 April 2001 the 23 GAD staff involved in prudential regulation of insurance were transferred to the FSA.

2.3 We note that under the Treasury's Service Level Agreement with the FSA (2.4.5/8), "the FSA's aim will be effectively to regulate the insurance industry so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations". Among the FSA's "key supporting objectives" is carrying out "the regulation of insurance companies...efficiently and effectively". It is also responsible for "protecting policyholders against the risk of company failure and, more specifically, to protect them against the risk that UK authorised insurers might be unable to pay valid claims. *In the case of life insurance companies this includes the risk that they will be unable to meet policyholders' reasonable expectations*".

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<sup>6</sup> The acronym ID will be used for the Directorate under both DTI and the Treasury.

<sup>7</sup> Baird observes that "Since 1994, GAD has operated a major part of life insurance supervision, as a delegated responsibility under the terms of a service level agreement originally with the Department of Trade and Industry, subsequently with Her Majesty's Treasury and now with the FSA..." (2.8.3)

2.4 Until 1/12/2001 – which embraces the period of interest of this report - the Insurance Companies Act 1982 as modified by the Transfer of Functions Insurance Order 1997, and supplemented by the Insurance Companies Regulations 1994, provided the statutory basis for the government’s prudential powers to regulate with-profits life funds. The Financial Services Act 1986 provided the basis for conduct of business regulation. These Acts and the Regulations were repealed by the Financial Services and Markets Act 2000. We outline the key provisions of these acts in the Annex, together with some aspects of the Insurance Company Regulations 1994, and some aspects of EU directives.

2.5 We observe that the tone of the three Acts we have cited is paternalistic; they provide “authorities” with powers which they can exercise vis-à-vis companies providing insurance business (and for which they are not liable in law); *they neither provide the consumers of such services with statutory rights vis-à-vis the providers, nor do they provide consumers with redress against the “authorities” when the latter are guilty of regulatory failure, however grave the fault of the authority.* Although we regard this style as inappropriate in this day and age, and is in marked contrast to the style of legislations in the US and Australia, it should be regarded as putting a strong onus on the authorities to act vigorously on behalf of consumers, especially as consumers are liable to be lulled into a false sense of security because the life companies are “regulated” by the government. As we will argue, the regulatory authorities have *completely* failed the majority of policyholders of The Equitable.

2.6 In preparing our submission we draw very heavily on the “Report of the Financial Services Authority on the Review of the regulation of The Equitable Life Assurance Society from 1 January 1999 to 8 December 2000”<sup>8</sup> (**the Baird Report or Baird**); unqualified numbers in brackets refer to paragraph numbers in the Baird Report. Indeed most of our submission is a summary and focused recasting of material in the Baird report. We found it an excellent factual source covering events from 1997, but this means we are short of evidence about regulatory performance over the period 1990 to 1996 when the foundations of The Equitable’s failure were laid<sup>9</sup>. *It should have been clear by the late 1980s/early 1990s, when long-term gilt yields and annuity rates were falling (see Appendices 7 and 9 of Baird), that The Equitable was not capable of withstanding falling interest*

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<sup>8</sup> The Stationery Office, 16 October 2001.

<sup>9</sup> In an interview between Howard Davies, the chairman of the FSA, and Grant Ringshaw in the Sunday Telegraph, 24 November, 2002 we read the FSA’s claims that “the die had been cast well before the regulator [i.e. the FSA] took effective responsibility for the insurance industry in January 1999”. We wonder whether the Treasury/FSA carefully selected the period which The Baird Report covered to avoid exploring the earlier period.

*rates because of its excessive bonuses and onerous guarantees. In view of its weak financial position it was improper for The Equitable to be issuing policies without guaranteed annuity options (GAOs)<sup>10</sup>. The regulator knew, or should have known what was going on, and taken action such as closing the fund. It did nothing. **We hope that the Inquiry will examine carefully the period after the personal pension plans (without GAOs) were introduced in 1988.***

2.7 In view of its brief, Baird did not comment on regulatory shortcomings prior to 1 January 1999, and in our opinion it was sparing in its identification of failures by the FSA over the Review period<sup>11</sup>. It could – and in our view should – have stated in a straightforward manner that the FSA failed seriously in its duty to regulate The Equitable in the various respects that we have identified. It might further have added in plain English rather than code, that these failures were due to a combination of inertia, technical ineptitude, and a preference for keeping heads well below any parapets and not rocking any boat. Although the Chairman of the FSA did forego part of his bonus for 2000, we note that in the customary manner of the civil service there is no evidence that heads have rolled for what we will show is significant incompetence which has cost hundreds of thousands of people dearly.

2.8 In addition we draw on a report prepared for us by accountants Burgess Hodgson “The Equitable Life Assurance Society – The With Profits Fund 1993-2000”, which we provided separately to the Inquiry as EMAG’s first submission. This report attempts first to back-cast from 2000 to 1993 the extent to which The Equitable was “over-declaring” terminal bonuses. Second, the report shows that The Equitable’s non-profit business was a drain on the with-profits fund.

2.9 Although the decision by the House of Lords (HL), which rendered illegal The Equitable's practice of setting lower terminal bonuses for policyholders who exercised their GAO, has attracted most of the attention of commentators discussing The Equitable. We will show that it was in fact only one of several factors that led to Equitable’s difficulties and to the reduction of policy values by 16% on 16 July 2001; by a further 4% on 15 April 2002; and by another 6% on 1 July 2002, and to the reduction of income for with-profits annuitants by up to 20% following their annual review dates after February 2003, with further falls to come. At the time of the HL case The Equitable estimated the cost of the GAO liability at £1.5bn, which represented about 5.3% of the with-profits fund of £26bn. The £1.5bn was notionally “collected” by declaring no bonus for the first seven months of

<sup>10</sup> For consistency we have translated Guaranteed Annuity Return (GAR) into GAO.

<sup>11</sup> Either by design or by chance, the Report was structured in such a way that the true enormity of the incompetence of regulation was fragmented among several chapters. What we have done is to bring the bits of the story together.

2000. The Directors of The Equitable hoped for growth of above 10% in 2000, and if this had happened the bonus freeze would have retrieved the GAO loss. But growth was minimal at 2.7% and, as can be seen from the regulatory returns, was absorbed by the non-profit fund<sup>12</sup>. In the event the GAO issue was (according to The Equitable) resolved in the compromise settlement of 2002 for about £900m.

2.10 There were other – and in total much more significant – reasons for the reduction in policy values than the GAO issue, namely:-

- the over-declaration of terminal bonuses during the 1990s weakened the fund as those who left it with contracted exits prior to 16 July took more than their asset share<sup>13</sup>. By 31 December 2000, at the end of a long bull market, The Equitable should have built up a smoothing reserve of at least 5% of the value of the fund (say £1½bn). But in consequence of the over-declaration of total bonuses, according to the Independent Actuary “Policy values exceeded assets by 10%”<sup>14</sup>. The excess represented a sum of about £2.6bn, of which Burgess Hodgson assume he attributed £1.9bn to the GAO issue (which was the provision made in the 2001 accounts). *Excluding the allowance for the GAOs, the “smoothing fund” was short by at least £2bn, while, including it, the smoothing fund was short by about £4bn*<sup>15</sup>
- the over-declaration of guaranteed<sup>16</sup> bonuses in the 1990s meant that The Equitable was consistently financially weak
- the fall in the value of the stock market by 25% from the end of 2000 (when the FTSE was 6223) to late June 2002 (when the FTSE was 4657) also contributed to the shortfall in assets. Fortunately the circumstances of the fund forced The Equitable to withdraw from equities; it had 50% in equities at the end of 2000; was down to 25% by mid May 2002; to 15% by the end of June 2002, and to 5% by September. *As a result the subsequent fall in the stockmarket was less financially severe for The Equitable than for other funds which retained a higher proportion of equities*<sup>17</sup>. Indeed the Daily Mail of 2 January 2003 reported that The Equitable was the joint top of the performance league table of life funds for the first 11 months of 2002
- The Equitable’s financial difficulties have been aggravated by its failure to address the problem of the guaranteed interest rate (**GIR**) provision of 3.5% p.a. that is attached to about 80% by value of the policies. The GIRs appear to be the main reason for the reduction in policy values in April 2002. With one hand the Board covered the GIRs and declared a non-guaranteed bonus for policyholders without GIRs of 2%, but with the other hand it took it away from policyholders who had a surplus over their contractual value by reducing policy values by 4%

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<sup>12</sup>Burgess Hodgson’s assessment.

<sup>13</sup> Also, from March 1997, when the market value adjustment was reduced to zero, until 8 December 2000, when the market value adjustment was increased to 10%, policyholders who took uncontracted exits took more than their asset share.

<sup>14</sup> P113, The Proposal to be effected by a scheme of arrangement, The Equitable, December 2001.

<sup>15</sup> All italicised script is italicised by us except where noted otherwise.

<sup>16</sup> We will use the term “guaranteed”, which is plain English and which The Equitable used, rather than the more common term “reversionary”, which is industry jargon. We will call the guaranteed bonus plus the terminal bonus which The Equitable declared as the “total” bonus.

<sup>17</sup> The chairman and chief executive of The Equitable have frequently and incorrectly blamed the fall in the stock market disproportionately for The Equitable’s woes.

- The Equitable has had to make provisions for mis-selling, which include £420m for payments under the Rectification Scheme to policyholders with GAOs that matured prior to the HL decision and for mis-selling of drawdown schemes, and £212m for mis-selling liabilities (this includes provision for mis-selling to those who left the with-profits fund prior to the ratification of the compromise scheme)

2.11 We consider that there have been seven regulatory failures:-

- (i) allowing it to over-declare its terminal bonuses so that total bonuses were above the Society's asset value. The Equitable was in effect allowed to run something akin to a Ponzi fund
- (ii) allowing The Equitable to expand when its solvency position extremely weak and was propped up with financial engineering
- (iii) recognising by the late 1980s/early 1990s that The Equitable did not have the financial strength to bear the risk of significant falls in annuity rates other than by penalising policyholders without GAOs, and taking action at very least to force it to reserve and to charge for them
- (iv) allowing The Equitable to continue to sell with-profits policies after the decision by the HL
- (v) failing to take action to mitigate the consequences of the HL decision for policyholders without GAOs
- (vi) failing to ensure that policyholders and prospective policyholders received adequate information about the financial situation of The Equitable
- (vii) failing completely in conduct of business regulation, which did nothing – absolutely nothing – to protect policyholders and prospective policyholders

2.12 We make some of our criticisms with the benefit of hindsight. But we do not regard this as any shortcoming on our part. We members, both as policyholders and as owners of The Equitable, were not privy to either the information that would have enabled us to judge its financial situation, nor to the discussions that went on behind closed doors which are described in the Baird Report and repeated in this report.

2.13 We hope that the Inquiry will probe with particular care one aspect of the history; did the gross regulatory failure on the part of the responsible authorities with regard to The Equitable exemplify a general regulatory failure that was equally grave in the case of other life offices as well as The Equitable? Or was it, as some suspect, much worse in the case of The Equitable because the authorities were, for policy reasons unconnected with the intended regulatory regime, anxious not to “rock the boat”. Namely, it was a mutual that did not pay commission to intermediaries, had low charges, and may therefore have been seen as a model for the provision of “stakeholder pensions”

and the like in the future. Not only will the answers to those questions have implications for the future of regulation in this field generally; the answers may also be significant in the context of legal liability, or a special moral responsibility on the part of the government to provide compensation to The Equitable policyholders who have suffered as a result of grave regulatory failures.

2.14 Finally, we observe that while much of the blame for the regulatory failure falls upon GAD, the problems of The Equitable reflect in part a failure by the actuarial profession in general, just as the collapse of Enron reflected a general failure by accounting auditors. It would be most unfortunate – and inappropriate - if the actuarial profession adopted the attitude of “it could not happen to us”, when its members should be saying “there but for good fortune go I”.

### 3. ALLOWING THE EQUITABLE TO OVER-DECLARE TERMINAL BONUSES

3.1 The study by Burgess Hodgson of the accounts and solvency returns over the period 1993-2000, which worked back from the Independent Actuary's statement in the compromise agreement that at 31 December 2000 "Policy values exceeded assets by 10%"<sup>18</sup> showed that the Society had a consistent policy of declaring overall (i.e. guaranteed plus terminal) bonuses on its pension business that resulted in policy values that were persistently in excess of the value of the assets<sup>19</sup>. The new chief executive managed to continue this practice by declaring an interim bonus of 8% on 5 March 2001, even though it should have been clear by then that the return in 2000 was very low, the stock market was at best going sideways, and that a priori there was no reason for thinking that returns would continue to be high (in the event the return on the fund was -6% for 2001). The accountant's analysis found as follows (all figures are %):-

Year	1990 <sup>20</sup>	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Announced investment return	-8	14	17	29	-4	17	11	17	13	16	3
Guaranteed bonus including GIR	8.5	8.5	8.5	7.5	7.5	7.5	7.5	6.5	5.0	5.0	3.5
Overall bonus (Pension business)	12	12	10	13	10	10	10	13	10	12	3
Surplus/deficiency as a proportion of assets											
-excluding GAR cost	-26	-21	-11	4	-12	-7	-8	-5	-2	0	-3
-including GAR cost	-26	-21	-11	4	-12	-7	-8	-10	-10	-5	-10

3.2 Clearly the purpose of declaring high total bonuses, which resulted in plaudits from commentators and also awards, was designed to promote new business. The over-declaration of total bonuses had the following consequences:-

- except for 1993, policyholders who took contracted exits during the period 1990 to 15 July 2001 either took out more than their asset share or, if they took an annuity from The Equitable, involved a liability in excess of their asset share<sup>21</sup>. For example we estimate that in the period 1 January – 15 July 2001 (when policy values were reduced by 16%), policyholders taking contracted exits benefited by about £200m in excess of their asset share. *During this period the*

<sup>18</sup> Unfortunately due to an unnecessary lack of cooperation by the chief executive of The Equitable, the accountants had to make assumptions both about the figure to which the Independent Actuary's reported over-bonusing applied, and also the figure which he assumed for the cost of the GARs. We hope that the Inquiry will clarify, and if necessary correct, the figure.

<sup>19</sup> Evidence by Charles Plant, a senior partner of Herbert Smith acting on behalf of The Equitable in the case against Ernst & Young, states in para 8 "Between 1998 and 2000, policy payouts exceeded the underlying asset shares. Burgess Hodgson's figures show the period was much longer.

<sup>20</sup> Figures for 1990-92 were calculated separately from the Report.

<sup>21</sup> Also policyholders who took uncontracted exits in the period March 1997 to 8 December 2000, when the market value adjustment was either 5% or zero, took out more than their asset share.

*FSA were deeply involved in investigating The Equitable, and should have intervened and prevented the 8% interim bonus declared in March 2001*

- those who exited the fund with money in excess of their asset share did so at the expense of the policyholders who remained and of those who joined the Society. The course pursued by The Equitable undermined their “reasonable expectations” since they did not expect to cross subsidise other policyholders
- The Equitable could only operate this policy while its with-profit total cash inflows from earned premiums exceeded outflows from claims incurred, which according to Burgess Hodgson was the case until 2000:-

	1993	1994	1995	1996	1997	1998	1999	2000
	(£m)	(£m)	(£m)	(£m)	(£m)	(£m)	(£m)	(£m)
With-profit fund net cash flow	549	632	719	951	953	778	493	243

*The Equitable was in effect running something akin to a Ponzi scheme which would – and did – fall apart once policyholders started to leave in significant numbers.*

3.3 As we observed above, on 31 December 2000, at the end of a long bull market by when The Equitable should have built up a smoothing reserve of at least 5% of the value of the fund (say £1½bn), there was a “negative smoothing fund” due to over-declaration of terminal bonuses. *Excluding the allowance for the GAOs, the “smoothing fund” was short by at least £2bn, while including it the smoothing fund was short by about £4bn.*

3.4 As the Baird report makes clear, GAD was not only aware of the over-declaration of terminal bonuses but relaxed about it. The scrutiny report prepared by GAD dated 8 December 1997 in respect of The Equitable’s 1996 regulatory returns noted that “it seemed likely that the current asset shares exceeded the admissible assets” (4.3.5), which the Appointed Actuary confirmed (4.3.6). “GAD’s response to the Appointed Actuary’s letter was the fact that the total face value of the policies was higher than Equitable Life’s admissible assets did not necessarily cause GAD any concern” (4.3.8).

### **Regulatory failure**

**3.5 As Baird observed “Terminal bonuses are not guaranteed but there must be sufficient surplus available to pay for them” (3.26.5). The casual attitude of GAD was a major regulatory failure resulting in many policyholders leaving the fund with more than their asset share, weakening it for those who stayed or joined subsequently, and leading directly to undermining policyholders’ reasonable expectations which – as night follows day - were hit savagely in 2001 and 2002.**

#### 4. ALLOWING THE EQUITABLE TO EXPAND WHEN IT WAS FINANCIALLY WEAK<sup>22</sup>

4.1 In 1990 the assets of The Equitable's with-profits fund totalled £5bn, while in 2000 they totalled £26bn, representing a five fold increase in asset value over the decade, which was well in excess of the average fourfold growth<sup>23</sup>, and among the fastest, if not the fastest, growth in the industry<sup>24</sup>. While part of the reflected growth in stock market values and inflation, a significant part represented real growth. This growth was based on a weak capital base at the beginning of the decade. In an exhibit on p65 the Baird Report shows the relationship between "Asset Shares versus Statutory Reserves" and points out that "the unadjusted asset share is less than the statutory reserves at the outset of the policy, principally because of the high level of acquisition costs...At this state of a policy's life, it is a net absorber of capital". As The Equitable has observed, this expansion increased the strain on solvency<sup>25</sup>.

4.2 Chapter 4 of the Baird Report, titled "Solvency of Insurance Companies", brings out both the financial weakness of The Equitable and the matching weaknesses of the ID and GAD in regulating it. This chapter sets out the long story of the regulator's concern about the financial weaknesses of The Equitable, and the little the regulator did about those concerns.

4.3 The Equitable's basic solvency margin<sup>26</sup> was as follows:-

	1993	1994	1995	1996	1997	1998	1999	2000
margin as % assets	13	7	9	7	6	5	8	1

As has been often publicly stated<sup>27</sup>, The Equitable sought to run its with-profits fund rather like a managed fund in the sense that it aimed to distribute "the whole of the surplus arising from the existing policyholders" (3.11.4), and so it was not building up an "orphan" or "free" estate which

<sup>22</sup> The financial strength of a life assurance company is gauged by the excess of its assets over its required minimum margin, which is called the free asset margin ratio.

<sup>23</sup> According to the Association of British Insurers invested assets in long term business increased from £257bn in 1990 to £1043bn in 2000, representing a quadrupling in value.

<sup>24</sup> The Equitable's draft Re-Amended Particulars of Claim states that "from 1996 to 1998 the Society consistently rated at or near the top of all life assurance companies in terms of new business premium income *thereby increasing its strains on solvency*", cited in the Submission of Ernst & Young, Claim No. 2002 F339, In the High Court of Justice, Queen's Bench Division, Commercial Court, between Equitable Life Assurance Society (Claimant) and Ernst & Young (defendant).

<sup>25</sup> See previous footnote.

<sup>26</sup> As per line 25 of Form 9 of its solvency returns after adjusting for subordinated liabilities. Note that the figures include substantial provision for GAOs from 1998 onward.

<sup>27</sup> The Equitable's business model of likening a with-profits fund to a smoothed managed fund based on asset shares was explained in "With-profits Without Mystery", R.H. Ransom and C.P. Headdon, presented to the Institute of Actuaries,

results in a intergenerational redistribution of assets. As a consequence it had little or no cushion against investment and other shocks. The policy objective might have been fulfilled without significant financial risk if The Equitable had adopted a conservative policy of declaring modest guaranteed bonuses so that it was financially strong, and then relied on terminal bonuses to provide flexibility. The Equitable did not, however, adopt such an approach. Rather, it was aggressive in declaring guaranteed bonuses and in consequence the fund was financially weak, and as we saw in chapter 3 it did the same with terminal bonuses. It pursued these policies to support its marketing objective of growth. The regulatory authority acquiesced to this policy.

4.4 According to Baird (4.3.1/2) “The regulator’s view of Equitable Life’s financial position at the end of December 1996 is evident from the scrutiny report dated 8 December 1997 prepared by GAD in respect of Equitable Life’s regulatory returns”. The scrutiny report noted that:-

“about 65% of its liabilities relate to unitised with-profits business, for which it endeavours to show competitive annual accumulations of benefits reflecting the total investment returns achieved, but because guaranteed bonuses include credit for a measure of asset appreciation, future bonus declarations of the Society would seem to be vulnerable to any sustained stockmarket downturn. It has a modest free estate. Some questions have been raised about the strength of the reserves established”.

4.5 GAD gave The Equitable a priority rating of 3, which “denotes a company where there are sufficient concerns to warrant early attention or other reasons to require GAD to carry out its scrutiny early in the cycle”. In closing the file GAD wrote to ID that (4.3.10) “I am happy to confirm that our discussions did not conclude that any particular strengthening of their reserves was needed in relation to accumulating with-profits business, although I remain concerned that not all holders of such contracts (with this and other offices) appreciate what could happen at future bonus declarations if we saw a sudden downturn in the market value of assets. The whole industry is relying on a soft landing, so that reductions can be achieved gradually and without trauma”. *(Perhaps this quotation should be pinned to the wall of the Government Actuary’s office).*

4.6 Notwithstanding its priority rating “no detailed scrutiny was produced by GAD in 1998 in respect of its 1997 regulatory returns. We were told in interview that this was because Equitable Life was given a priority rating of 4 (sic) in 1997, and its regulatory returns would have been scrutinised in March 1998, although because of the ongoing dialogue with the regulator GAD knew

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20 March 1989. Ransom was at that time the Appointed Actuary of The Equitable and Headdon became the Appointed Actuary in 1997.

“where all the issues” were<sup>28</sup> and scrutinised the 1997 returns, with the 1998 returns, in 1999” (4.13.1).

4.7 In a letter to the Appointed Actuary dated 16 January 1998, GAD stated that (4.3.8):-

“the lack of any...free estate does bring to prominence the importance of not building up policyholder expectations too far with the implication that it might then be considered necessary to hold reserves or anticipated final bonus additions. I am sure that you are acutely aware of this”.

4.8 In a briefing note to the FSA on 5 November 1998 ID expressed its concern as to The Equitable’s ability to reserve adequately: “The information received to date is unconvincing, and raises serious questions about the company’s solvency” (4.19.2). (Note that The Equitable was the only company on which ID briefed the chairman and the relevant managing director of the FSA in preparation for the handover of regulatory responsibility from the Treasury to the FSA on 1 January 1999). A further briefing note (4.19.3/4) set out the free asset position if The Equitable reserved for 100% or 25% of GAOs, and stated that Equitable was just solvent if it reserved fully for its GAOs. The briefing also stated:-

“However, it should be noted that the free asset figure makes no allowance for the declaration of bonuses. The costs of annual bonuses, assuming they are maintained at their current level is £500m, so the company would appear to have insufficient assets to declare a bonus in 1999. Also it should be noted that £850m of the assets available to cover the required minimum margin (RMM) are implicit terms (allowance for future profits). Only 5/6<sup>th</sup> of the RMM can be covered by implicit terms. The company is therefore close to breaching this requirement when GAOs are fully reserved for. A relatively small fall in equities or gilt yields could wipe out the company’s explicit free assets”.

4.9 The note also set out a strategy for regulatory action (4.19.5/6/7). At a meeting before Christmas 1998, The Equitable was to be told that its proposed reserving approach was not acceptable, and if the FSA decided that the regulatory returns were not compliant with the Regulations, the FSA would take action. In addition, it was intended to seek an undertaking from The Equitable that it would not declare any further bonuses without prior discussion, and the note contemplated closing The Equitable to new business. *Baird does not, unfortunately, explain how these bold musings evaporated when the FSA assumed formal responsibility in the New Year.*

4.10 According to Baird, the first days after the FSA assumed regulatory responsibility on 1 January 1999 were taken up with considering and criticising a legal opinion that The Equitable had obtained from leading counsel on its approach to reserving. “GAD had some sympathy with the

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<sup>28</sup> In view of GAD’s subsequent ignorance of many issues, see paragraph 10.4, this was a suspect claim.

points made by counsel regarding the size of the one-off reserve (£1.5 billion) and the fact that to make it would affect all policyholders in the form of reduced bonuses in future years. GAD said that it could consider some phasing-in of higher provisions when it had seen some of the information which it asked IFSD to request from Equitable Life, which help them consider the ramifications of the increased provision in the context of policyholders' reasonable expectations" (4.23.8). On 11 January 1999 IFSD wrote to The Equitable stating "that the Opinion had not changed IFSD's view on reserving as set out in ID's letter to Equitable Life dated 7 December 1998, and, most importantly, did not appear even to address IFSD's position" (4.24.2). It also observed that the statements in the regulatory returns were "brief in the extreme and do not disclose the reserving method, the rate of guarantee or the volume of business affected".

4.11 In a minute dated 29 January 1999 GAD gave advice to the FSA on various Board papers that The Equitable had supplied to IFSD relating to the proposed declaration of bonus. The advice noted that The Equitable was sensibly seeking to balance the considerations of reducing progressively the amount of additional guaranteed benefits added each year with maintaining a reasonable competitive position and smoothing bonus declarations from year to year in line with the perceived expectations of policyholders. The advice further stated (4.27.4):-

"The cost of the declared bonus for 1998 would be some £365m (compared with £508m in 1997). This would leave the overall financial position of the company as shown in their draft 1998 returns as showing cover of 250% for the solvency margin (i.e. similar to 31/12/97) assuming that the reinsurance with ERC is completed (and accepted by FSA as allowing a significant reduction in the reserves for GARs), or 110% if the ERC reinsurance is not taken into account. In the latter situation, they would though be able to take credit for a larger future profits implicit item that could boost the apparent solvency margin cover to around 200%, though the explicit cover for the guarantee fund would be very thin. Therefore the financial position shown in their 1998 supervisory returns is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under Section 33 [of the ICA 1982] if their proposed reinsurance is not completed satisfactorily. Accordingly, I believe that it would be difficult to object formally to their proposed course of action, though we would need to continue to monitor their position carefully".

The advice also noted:-

"There are also a fairly substantial level of guarantees on most of their older policies. Meanwhile, they continue to issue annual notices to policyholders showing a high level of projected benefits and thereby generating future expectations. Therefore, in writing to them to say that we have no objection to their current proposed rate of declared bonus, I believe that we should voice our concerns about their apparent vulnerability to changing investment conditions".

4.12 On 29 January 1999 GAD advised that The Equitable's financial position shown in its 1998 regulatory returns (4.28.5):-

“is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under section 33 [of the ICA 1982] if their proposed reinsurance is not completed satisfactorily”.

4.13 IFSD advised The Equitable that, “in the absence of a **robust reinsurance** agreement along the lines which had been discussed, IFSD would not consider it prudent for Equitable Life to declare any bonus for 1998” (4.28.6). Furthermore, IFSD told The Equitable that even with the reinsurance, The Equitable needed to consider carefully the scope for declaring a bonus because of the uncertainties surrounding the financial implications of the court case. But it did “consider these points to be, in the first instance, a matter of judgement for Equitable Life, on which the company must satisfy itself appropriately”. And it confirmed that, on the basis of the information received and assuming the reinsurance agreement was revised to resolve GAD's concerns it was not minded to object to the proposed bonus declaration (4.28.7/8).

4.14 In mid-March 1999 a note was circulated within IFSD that, among other matters, reported on the effect of GAO's on The Equitable's statutory solvency position (4.33.1). The attachment to the note stated:-

“The company's financial position has been very severely affected. Its policy is to distribute as much of its profits to policyholders as possible, consequently it has not built up an estate which can be used to meet the unexpected costs such as those arising from GAOs and as a mutual it has no ready mechanism for raising additional capital”.

The note also stated:-

“We remain concerned about the financial viability of the company in the longer term. It has declared high levels of guaranteed bonuses in the past and its ability to honour these guaranteed bonuses appears heavily dependent on the company continuing to achieve high investment return. The company's liabilities for GAOs could also increase significantly if the yields on long gilts fall further”.

4.15 Eventually, under pressure from the FSA, The Equitable agreed to declare a reduced guaranteed bonus of 5%, but it still declared a total bonus of 10%.

4.16 On 29 July 1999, **seven months after The Equitable had announced its intention to bring a test case**, ID and GAD and the General Counsel's Division of the FSA met with the Chief Executive and Appointed Actuary of The Equitable **for the first time** to discuss the court case (4.42.1). It noted that “the relatively low free asset position together with Equitable Life's mutual

status (making the raising of external capital difficult) and the high levels of reversionary bonus which had traditionally been declared meant that the company was potentially highly vulnerable to a change in economic circumstances. A sustained period of low investment returns – particularly if it was associated with a substantial fall in equity prices – could be particularly damaging” (4.46.6).

4.17 “At the end of August 1999 IFSD prepared an Initial Risk Assessment of The Equitable...The overall summary stated that Equitable Life was seen as a “high financial risk because of the level of benefits guaranteed to policyholders, the relatively low free asset position and the difficulty it would face in raising external finance. Equitable would be particularly vulnerable to a sustained and significant fall in equity prices” (4.46.1).

#### An omission from consideration by GAD

4.18 According to Baird (4.7.2) The Equitable’s regulatory returns included a statement that “½% p.a. of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses”, and it reported that “The negative impact on solvency of removing the ½% was estimated by Ernst & Young to be just under £1 billion” (6.9.2). Also according to Baird (4.7.2) “No questions were asked of Equitable Life by the regulator about the charge...which was referred to by the Appointed Actuary as being in the nature of a Zillmer adjustment”<sup>29</sup>, until “eventually GAD was alerted to the issue in late 2000” (6.9.2). Baird commented (6.9.2) that this issue “should have been questioned”.

#### Another omission from consideration by GAD

4.19 Throughout this period neither ID nor the GAD picked up the drain on The Equitable’s with-profits fund from its non-profit business, and Baird did not refer to it. Yet according to Burgess Hodgson’s analysis The Equitable’s non-profit business<sup>30</sup> was a significant burden on the with-profits fund over the latter half of the 1990s:-

<sup>29</sup> The Equitable was not using Zillmerising (which applies to regular premium policies) since it had largely single premium contracts. It was making an adjustment to its projected investment return to take account of the recovery of expenses, and this had an impact on the amount that it had to retain as a resilience reserve. Under the valuation technique it was using, it was reducing the estimate of its liabilities by “just under £1 billion”.

<sup>30</sup> The non-profit business comprises contracts where the policyholders do not share in The Equitable’s profits, and includes conventional annuities and term life cover. The actuarial returns show that the cost of annuities increased as interest rates fell. The same effect increased the value of the gilt edged stocks bought to match the annuities. In this sense the non-profit business did not make a loss (or at least not one that is evident). However an equivalent proportion of the investment growth ‘belonged’ to annuitants and was thus not available to with-profit investors, eroding the benefit to the with-profits fund by the same amount.

	1996 (£m)	1997 (£m)	1998 (£m)	1999 (£m)	2000 (£m)
Contribution (burden) <sup>31</sup> to the with-profits fund	(245)	(230)	(383)	69	(368)

4.20 The Equitable was very competitive in term assurance, where it did not differentiate between smokers and non-smokers in the rating basis, although it may have been very strict in their underwriting. Additionally, it offered very competitive conventional annuity rates. *We suggest that the Inquiry examine whether these classes of business had matched investments, and whether appropriate reserves were made to cover any mismatching and the mortality risk.*

### **Regulatory failure**

**4.21 Although The Equitable was a very weak fund and the regulator knew it, GAD was dilatory in undertaking its scrutiny analysis<sup>32</sup> and in meeting the Chief Executive of The Equitable after it had started legal proceedings; until late 2000 it missed the almost £1bn significance of a statement that The Equitable made in its return regarding deducting ½% p.a. on the benefit value; and it never picked up the burden on The Equitable’s with-profit fund from non-profit business.**

**4.22 Despite huffing and puffing about regulatory action, possibly closing The Equitable to new business, and requiring it to sign a “robust” reinsurance treaty, as we explain in chapter 5, in addition to significant support from a future profits implicit item, it was satisfied with, and attributed large asset values for the purposes of calculating the solvency margin, a large subordinated loan and a reinsurance treaty, both of which were mere financial engineering. GAD eventually pointed out regarding Equitable’s solvency position in 1999 “*at first sight the solvency position looked reasonable, but the available assets of £3,861m to cover RMM of***

<sup>31</sup> Note that to try to avoid actuarial nit pickery Burgess Hodgson carefully did not use the word “loss” but stated:-  
 “Our figures suggest that the non-profit aspect of the Society's business has absorbed a considerable part of the Society's investment return during the late nineties...It would not be accurate to describe the above as 'losses', since we would expect them to be broadly matched by investment gains on the Government Stocks held to pay the annuities. However, that part of the investment growth, which is needed to fund the increased cost of annuities, is not available for the benefit of the with profit fund and has to be excluded.”

The chief executive of The Equitable managed to misunderstand this careful wording, and made the superficial observation that “there was a serious error in the analysis”. He subsequently realised the error of his ways.

<sup>32</sup> According to Baird, the dates GAD completed scrutiny reports were as follows:-

report for the year	return provided by The Equitable	completed on	period to complete (months)
1996	25/6/1997	8/12/1997	5
1997	24/6/1998	20/5/1999	11
1998	30/3/1999	20/5/1999	2

***£1,114m included a future profits implicit item of £925m<sup>33</sup>, disregarded the liability to repay a subordinated loan of £346m and benefited from a reduction of almost £1.1bn in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511m, “a less satisfactory picture for this large fund” (4.59.39). The regulatory authority supinely acquiesced in the policy adopted by The Equitable during the 1990s to grow rapidly; acquiesced in it pulling most of the tricks in the book to window dress its solvency return; and failed to pick up the quasi-Zillmerising.***

1999

26/6/2000

24/11/2000

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<sup>33</sup> Since 1994 The Equitable has applied for, and been granted annually, a Section 68 Order permitting a proportion of future profits to be included as an implicit item in the calculation of its solvency margin. The amount applied for – and granted – increased from £500m in 1994 (when £250m was used in the solvency returns) to £1900m in 1998 when £850m was used, reducing to £1000m in 1999 when £925m was used. About £1bn was used in 2000.

## 5. DELAYING ADDRESSING THE EQUITABLE'S GAO ISSUE AND THE INEFFECTIVE SOLUTION

5.1 In a letter to the Actuary magazine of November 2000, Professor David Wilkie of the Heriot-Watt University wrote about The Equitable:-

“Since GAOs cannot be hedged, one must fall back on setting up suitable contingency reserves to cover the risk, at least with some degree of safety. In 1980 the Maturity Guarantees Working Party Report<sup>34</sup> showed how one could use stochastic simulation to derive initial contingency reserves at a chosen probability level, and in a paper presented to the Faculty in 1984 I put forward an integrated stochastic model that included both shares and fixed interest. Such a model could have been used at that time to establish some kind of contingency reserves for the options that offices had written...

Reserving was one problem. The other was charging for the benefit. I do not know whether an explicit charge was made for the GAO in the premium for these policies but, if not, the only other place it could come from was the bonus. Bonuses, either reversionary or terminal or both, for policies with a GAO would have been lower than for policies with no GAO...However, I have seen no indications that the Equitable's GAO policies received lower bonuses than their non-GAO policies. Indeed...‘the company regarded policyholders’ reasonable expectations as synonymous with asset shares’. Asset shares may or may not be a reasonable terminal benefit for with-profits policies with guaranteed sum assured and reversionary bonus...but if asset shares are right for ordinary with-profits policies with no GAO, then they are too big for policies with a GAO.

Even if contingency reserves at, say, a 1 in 1,000 level had been set up at the end of 1984 for these policies (and the methodology was known by that time), these reserves might not have been enough. But their insufficiency would have emerged as interest rates fell and mortality rates improved during the 1990s, giving time to remedy the situation...

I do not know what action The Equitable's actuaries have in fact taken over the last 20 years or so, but all the reports suggest that they have blindly led their company to near ruin. Yet no blame seems to have been placed on them by the actuarial profession, *nor on the statutory supervisors, who were either not told that GAO policies existed, or did not enquire how they were being reserved for.*” (our italics).

5.2 In a very recent paper Professor Wilkie et al<sup>35</sup> introduced their paper “by going back to early 1985, by which date the up-to-date actuary, familiar with the then current U.K. actuarial literature, should have had sufficient knowledge to have been able to attack the problem of reserving and pricing for policies with GAOs, on the basis of our current work that had been published by that

<sup>34</sup> A. Ford, S. Benjamin et al, Report of the Maturity Guarantees Working Party, pp103-212, Journal of the Institute of Actuaries, 107, 1980. Note that Mr. D. Loades of GAD was a member of the Working Group.

<sup>35</sup> Reserving, Pricing and Hedging for Policies with Guaranteed Annuity Options, A.D. Wilkie, H.R. Waters and S. Yang, presented to the Faculty of Actuaries, 20 January 2003.

date, mainly the Report of the Maturity Guarantees Working Party<sup>36</sup>, and the Wilkie investment model, whose first version had been presented to the Faculty of Actuaries in late 1984, though not published until 1986”. The authors “also showed how the required reserves would have been quite small in 1985, but with ‘marking-to-market’ would have increased during the rest of the 1980s and the 1990s, so that offices that had written such GAOs would have built up funds which were sufficient to pay the required benefits and they would not have been caught unexpectedly. GAOs would still have been costly, but the costs would have been recognised more in advance. In addition, the fact that larger reserves were needed than many offices seem to have held would have alerted them to the dangers of writing policies with GAOs, and they might have stopped offering such benefits sooner than they did, and might have made more realistic charges to policyholders who wished such an option, rather than giving away a valuable benefit apparently free.”

5.3 In their conclusions the authors argue that “Several lessons can be learned from this paper. First, the methodology that we have used...was all known and publicly available by 1985. Further, [Actuaries] Guidance Note 8, first issued in October 1983, contained a relevant paragraph<sup>37</sup>:-

‘The prudent assumptions on which the reserve under Part IV must be calculated will naturally allow for stochastic variations as well as other contingencies. In determining the extent to which the actuary would consider it prudent to make provision for the more extreme stochastic variations in valuing particular categories of conduct (for example in relation to mortality and morbidity fluctuations, and variations in benefits resulting from the inclusion in a unit-linked contract of a maturity guarantee) he may reasonably take into account the basis of the solvency margin that the company is required to hold on account of the liabilities under those contracts (net of the permitted deduction for reinsurance cessions)...’

It is reasonable then for those outside the group of Appointed Actuaries to ask why few or no offices had either charged or reserved for these options (see the survey reported by Bolton et al., 1997<sup>38</sup>), and why the then supervisors did not ask offices whether they had set up the required reserves. *Of course, the supervisors may not have known that such benefits were being offered, but one wonders whether they have any obligation to be aware of what is on the market...’*. (Our italics). EMAG consider that this is a particularly pertinent question as Mr. C.D. Daykin, the current Government Actuary, chaired a Working Party on the Solvency of General Insurances which reported in 1987 and used Wilkie’s model<sup>39</sup>.

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<sup>36</sup> Op. cit.

<sup>37</sup> The authors quoted from the Faculty of Actuaries Year Book 1984-85.

<sup>38</sup> M.J. Bolton, D.H. Carr, D.H., et al, Reserving for annuity guarantees, Report of the Annuity Guarantees Working Party, sponsored by the Life Board of the Faculty and Institute of Actuaries, 1997.

<sup>39</sup> “Assessing the solvency and financial strength of a general insurance company”, Journal of the Institute of Actuaries (1987), 114 pp227-325.

5.4 *The answer to the question as to why the companies did not reserve for guaranteed options from the mid 1980s is that the regulator did not require such reserving, and as we will see did not act until 1998, more than decade and a half after the issue had been raised and the methodology for valuing the reserves had been developed. If the regulator had been doing his job properly, he would have realised that The Equitable, with its very low free asset ratio and well publicised policy stated in “With-profits without mystery”<sup>40</sup> of not maintaining an orphan estate, was singularly exposed to the risk of GAOs coming into the money and possibly imposing costs on policyholders who did not have GAOs. Furthermore if the regulator had fully analysed The Equitable’s position, then he would have found (as Burgess Hodgson did) that it was promising to deliver far more value to policyholders than it had assets, see paragraph 3.1. He should have been able to work out that The Equitable had broken three of the fundamental principles of insurance, namely it:-*

- had taken on a risk, but had set aside none of the premiums it had received to insure against the risk
- had not spread the risk. A very large percentage of its total book had a guaranteed rate written in, and none of it had been reinsured
- had vastly exceeded its capacity to bear this (or any other) risk. It had no shareholders to bear the risk or to provide additional capital, and it is clear from the 1990 Accounts that with a mere £210m in the fund for future appropriations, its smoothing kitty was substantially overdrawn

The Equitable’s response to the situation it found itself in the late eighties, was to launch and aggressively promote the new personal pension plans in 1988 which did not incorporate GAOs. But those who bought the personal pensions were being exposed to a very substantial risk. If interest rates had fallen sharply The Equitable would not have been able to meet its guarantees because almost all of the policies in issue had them. The Equitable might have argued that it had one margin for error, the policyholders’ terminal bonus. This would have been true if it had assets to support that terminal bonus, but as we have observed the terminal bonus was only partly covered by assets and consequently the margin for error was perilously thin.

There is an arguable case that those running The Equitable in the late eighties and early nineties might have been sailing very close to the legal wind<sup>41</sup>. *There is, however, less room for argument that if the regulator had been doing his job and had investigated The Equitable around 1990, he could – and should - have concluded that action should have been taken possibly to stop it taking on*

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<sup>40</sup> Op.cit.

<sup>41</sup> Carrying on a business with the intent to defraud the creditors (viz the non-GAO policyholders), would be a criminal offence under Section 458 of the Companies Act 1985.

*new personal pension plan business which did not have GAOs; possibly for the guarantees to be written out of existing policies; and at very least to commence reserving for the guarantees, and charging for them either from the premiums paid or by reducing the bonuses paid to policyholders with GAOs.*

We consider this failure to have been a foundation of subsequent problems, and a very serious regulatory failure that contravened the clearly implied purpose of s.45 of the Insurance Companies Act 1982 which empowers the regulator to “require a company to take such action as appears to him appropriate...to fulfil the reasonable expectations of policyholders or potential policyholders”. The subsequent inaction by the regulator in 1996 of allowing The Equitable to issue policies without a guaranteed interest return was a similar failure; the post 1996 policyholders bear the risk that if the net investment return falls below 3.5%, then they will have to fund the previous policies that incorporate a GIR.

5.5 In the early 1990s long term interest rates declined and longevity had been increasing, and consequently annuity rates declined. It should thus have been no surprise to the actuarial profession that GAOs would be coming “into the money” as annuity rates dropped below guaranteed annuity rates. The Equitable GAOs achieved value briefly in late October 1993, and then permanently after mid-1994 when the GAO increasingly exceeded open market current annuity rates. Paragraphs 65 to 75 of the 1994 Regulations impose requirements for determining the liabilities of a life fund. Regulation 72 requires provision to be made for options as follows:-

“(1) Provision shall be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts.

(2) Where a contract includes an option whereby the policyholders could secure a guaranteed cash payment within twelve months following the valuation date, the provision for that option shall be such as to ensure that the value placed on the contract is not less than the amount required to provide for the payments that would have to be made if the option were exercised”.

5.6 The effect of the 1994 Regulations and the professional obligations imposed on the Appointed Actuary is to require all life insurance companies to reserve on “prudent assumptions” for all guaranteed benefits and options exercisable by policyholders which could secure guaranteed benefits. GAOs should have been reserved from 1994, if not from the latter part of 1993. As we

will see, it took the actuarial profession another four years to address the issue and GAD another five to act<sup>42</sup>.

5.7 There are conceptually two parts to the GAO problem. First, is an increase in the value of the GAO on guaranteed policy values, *for which The Equitable should have reserved for from the mid 1980s if the regulator had understood the importance of the potential of the GAOs coming into the money, and without a doubt from 1994 if the regulator had been awake to the risk that the GAOs had come into the money.* Second, there is a potential value of the GAO on terminal bonus values. The board of The Equitable considered the GAO issue at a meeting on 22 December 1993, and hoped to resolve the problem by offering a differential bonus depending on whether a policyholder exercised the option or not (which the House of Lords ruled illegal). The claim by The Equitable against its former Appointed Actuary shows that it was aware in early 1994 that this approach might not be acceptable either to the members or to the regulatory authorities. Thus a note by Mr. Soundy, an actuary employed by The Equitable, to Mr. Ranson, then Chief Executive and Appointed Actuary, dated 13 January 1994 observed<sup>43</sup>:-

“[the] office is not acting with integrity and is effectively renegeing on its guarantees. Clients will expect that the full value of the fund will be available at retirement age to provide benefits. This is not consistent with having one fund value if GAOs are used and another higher value if they are not...While interest rates remain low, therefore, we will receive complaints about this approach. The longer the situation continues, the greater the likelihood that the complaints become serious. The worst scenario is that we are forced to change our practise and to compensate those who have already taken benefits”.

Four days later Mr. Soundy wrote:-

“Regarding our current approach I am suggesting that we may well be forced to change our approach by the regulatory authorities irrespective of our commitment to the approach”.

The Equitable mentioned the issue in its regulatory return for 1993.

5.8 In November 1997 a Working Party of the Life Board of the Faculty and Institute of Actuaries (which included a member of GAD) prepared a report which estimated that about £35bn worth of life business had GAOs attached, and identified various approaches for reserving for

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<sup>42</sup> The Treasury Committee, Tenth Report, Equitable Life and the Life Assurance Industry: An Interim Report, Volume I, 27 March 2001, The Stationery Office Limited, observed “It is unclear to us why the issue of GAR liabilities and reserving was not considered by the prudential regulator at least by 1993, rather than only in 1998. We believe that the current inquiries should pursue this closely” (paragraph 12).

<sup>43</sup> Between The Equitable Life Assurance Society, Claimant, and Christopher P Headdon, Defendant, in the High Court of Justice Queen’s Bench Division Commercial Court, 2002 Folio No. 406, April 2002.

GAOs<sup>44</sup>. The approach of differentially adjusting terminal bonuses (which was adopted by The Equitable) was viewed as being unsound because no explicit provision was made for explicit guarantees. In June 1998 GAD initiated its own survey of reserving practices for GAOs. On 29 July 1998 the Appointed Actuary of The Equitable submitted a response to GAD's survey showing that it had made no explicit provision for GAOs in setting its reserves and that its investment policy did not take account of the guarantees. Also "The Equitable disclosed that GAOs did apply in most contracts to increments to existing policies" (4.14.9), so that the eventual potential liability was open ended<sup>45</sup>. *This knowledge is a significant factor supporting our later criticism of the FSA in allowing The Equitable to remain open after the decision by the HL.*

5.9 On 1 September 1998 GAD advised ID that "whatever is the technical position, it must be remembered (that) these GAOs exist in large numbers, and threaten solvency in many cases and policyholders' actual, if not necessarily reasonable, expectations in more", and furthermore that "there is a risk of these becoming the regulator's problem" (4.10.2). GAD recommended that among other things that ID should "circulate all insurance companies referring to the issue of annuity options and guarantees and identifying the avoiding of these obligations as unacceptable behaviour". He also mentioned "that the existence of the options should be made known (*is this going a step too far?*)" (4.11.1). **The italics were in the original, and indicate both the secretive nature of the regulatory process and the wish not to frighten the horses, i.e. the (prospective) policyholders. The episode brings out the conflict between prudential regulation with a concern not to risk upsetting the market, and conduct of business regulation.**

5.10 According to Baird (4.14.1) "The exchanges between the regulator and Equitable Life in relation to GAO issues began with an exchange of letters on 21 September 1998", ***which was five years after the issue had emerged***, when ID wrote to The Equitable asking in particular about its terminal bonus practice "as we will wish to be satisfied that policyholders' reasonable expectations are being met" (4.14.1). Among other things ID observed on 19 October that "Meeting the costs of

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<sup>44</sup> M.J. Bolton, D.H. Carr, D.H., et al, Reserving for annuity guarantees, Report of the Annuity Guarantees Working Party, sponsored by the Life Board of the Faculty and Institute of Actuaries, 1997.

<sup>45</sup> The claim by the Society against its former Appointed Actuary states that "The GAO policies sold by the Society were considerably more flexible than those offered by other insurance companies. In particular:-

Policyholders could retire at any time within the permitted age range and receive the same benefits as if they had selected that retirement date at the outset.

Policyholders remained entitled to pay additional and increased recurrent single premiums into their policies, and to obtain the benefit of the GAR in respect of those premiums" (para 63 (b))".

the guarantees is putting a significant strain on the company's resources...It is feasible that the company could have to consider some form of demutualization depending on how serious the financial situation proves to be" (4.15.2).

5.11 On 5 November 1998 ID expressed its concern as to The Equitable's ability to reserve adequately, commenting "the information received to date is unconvincing and raises serious questions about the company's solvency" (4.19.2). Also around this time, under the heading "Policyholders' Reasonable Expectations", ID observed that there was a "Risk that the past practice could be found unacceptable so that [The Equitable] could be liable to pay guarantee on top of full fund" (4.16.20).

5.12 On 19 October 1998 ID wrote to the Economic Secretary to the Treasury that "Meeting the cost of the guarantees is putting a significant strain on the company's resources...it will submit updated information regarding its liabilities for GAOs and its resulting financial position in order that we can monitor this and take any action that becomes necessary to protect policyholders' interests. It is feasible that the company could have to consider some form of demutualization" (4.15.2).

5.13 At a meeting with The Equitable on 13 November 1998 GAD and ID "argued that it was a statutory requirement to reserve on (the 100% take-up) basis and unless Equitable Life could put up a compelling argument to the contrary we would expect the company to reserve on this basis". The Equitable argued against this view, claiming that from its experience it should be necessary to reserve for a take-up of only 25% of GAOs. Following a meeting on 3 December, "Intervention action was actively considered by ID" (4.15.12) but on 18 December The Equitable told ID that it had obtained "favourable" legal advice on the reserving question and it was prepared to take the matter to judicial Review" (4.15.15).

5.14 On 4 January 1999 GAD advised the FSA (4.22.1) that it should "set out in writing to The Equitable that the FSA was not satisfied with its level of reserving for GAOs". GAD also stated "On the subject of the earlier 1993-1996 returns, *I accept with hindsight that we might have addressed the issue rather earlier by asking some pointed questions about their guaranteed annuities. However, the presentation of their valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the return and*

*draw certain inferences from them. There was nothing said to indicate that the level or extent of these guaranteed annuities were regarded as significant” (4.23.4) (our italics).*

5.15 On 11 January 1999 the Government Actuary wrote a letter to the Appointed Actuaries of life assurance companies titled “Reserving for Guaranteed Annuity Options” requiring companies “to reserve fully for liabilities to provide for annuity benefits for the value guaranteed under the contract”. Paragraph 7 covered The Equitable’s approach to discounting the terminal bonus, and made the somewhat delphic observation that:-

“Where the levels of terminal bonus are to be adjusted with the aim of bringing the value of the guaranteed annuity option closer to the value of the alternative benefits, there might at first sight appear to be some room for argument that it was not necessary to reserve on the assumption that almost all policyholders will take the guaranteed annuity benefit. However, it needs to be remembered that, although the benefits formally “guaranteed” under the alternative form of benefit may be lower than those under the guaranteed annuity option, the company’s discretion in setting the value of terminal bonus applied to the alternative benefit is limited as a result of the existence of the guaranteed annuity. It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary”.

5.16 In late January the GAD advised on the reinsurance treaty that The Equitable was negotiating, whose intention (at this stage) was to maintain a reserve, in respect of policies with GAOs equivalent to providing for the additional cost of the guarantees of only 25% of the business rather than the 100% which the regulator was asking for, and “advised that it believed the reinsurance would not achieve the required reserving effect” (4.28.1).

5.17 On 9 April 1999 GAD provided IFSD with a memorandum reporting on GAD’s initial scrutiny of The Equitable’s 1998 regulatory returns. It noted that the gross reserve for GARs was “lower than we would have hoped for” and that “[the Appointed Actuary] appears to have made allowances for non-take up of [GARs]...to a greater extent than we thought he should, in the light of the [Government Actuary’s] guidance” (4.35.1).

5.18 Under pressure, The Equitable, which had “adopted a proportion of reserving between 70% and 82.5% depending on policy class” while the GAD pushed for 95% or greater (3.29.7), agreed to

increase the provision under the reinsurance contract to cover a 60% take-up of GAOs. If the proportion exceeded this, then the reinsurer would be liable to pay an amount which equalled the additional cost of them providing an annuity at the GAR over the cost of an annuity at current annuity rates. The reinsurer would subsequently recover, in instalments, any sums that it had paid to The Equitable from its future profits – note that some of these future profits were being capitalised and included as part of the assets on the solvency return – were they being used twice over? The premium paid for the reinsurance merely cost £400,000 payable for the first year and £800,000 thereafter, which does not buy much genuine insurance. *In fact the scheme was not reinsurance in the generally accepted sense of the word, but a rescheduling of payment for possible liabilities.* Effectively, the reinsurance enabled The Equitable to “park” its reserving problem with another institution that was not within the jurisdiction of the FSA, and, if things turned out worse than expected, to drip feed the hit on its balance sheet. The Appointed Actuary valued the reinsurance at £1.1bn in its contribution to the solvency margin, which is absurd. There is no evidence in Baird, that although GAD may have felt “discomfort” (see next paragraph), that GAD rejected The Equitable’s absurdly generous valuation.

5.19 As Baird observed (3.27.2/3): “Certain types of reinsurance also have financial objectives over and above simple transfer of risk. For example, some financial reinsurance can be used to improve the disclosed statutory solvency position of an insurance company, by obtaining reinsurance from a reinsurer located overseas, and not subject to the same requirements as a UK regulated insurance company”. In interview, GAD referred to this as “regulatory arbitrage” and told us:-

“We have always expressed our discomfort with these types of regulatory arbitrage arrangements and suggested to the companies that, if possible, the regulator may well seek to limit the benefits that can be derived from these arrangements. It is unsatisfactory, to the extent that the liability is going down a black hole, because you are taking it off the company’s books and somebody else is taking up a liability but not making any provision for it”.

5.20 The contract had only been agreed in principle by 1 April 1999 and was not finalised until 30 September. “On 21 April GAD advised IFSD...that although the reinsurance had not been signed, the intention to enter into it was sufficient for Equitable Life to rely upon its regulatory returns because GAD believed that the Insurance Supervisory Committee had agreed in principle that there was a letter of intent in place then credit may be taken for a reinsurance agreement” (4.35.5).

5.21 On 20 May 1999 GAD submitted its detailed scrutiny report on The Equitable's 1997 and 1998 returns, and noted that the Appointed Actuary "has somewhat stretched the concessions offered by the Government Actuary". An Action Point was a "policy decision needs to be taken about whether to challenge some of the assumptions made by the Actuary in setting the level of required reserves for GAOs" (4.38.1/2). IFSD thought that they should adopt a "low profile approach" to clarifying the issue, which meant that the GAD rather than IFSD should contact The Equitable.

5.22 On 15 July 1999 GAD wrote to The Equitable observing "we do still have some difficulty in accepting that reductions of between 17½% and 30% are consistent with the "few percentage points" quoted by the government Actuary in paragraph 6 of his letter dated 13 January 1999"<sup>46</sup> (see the last quotation of the letter set out at paragraph 5.11 above)

5.23 At the end of August 1999 IFSDS prepared an initial Risk Assessment of The Equitable, and under the section headed "Financial" and the sub-heading "Reserve/Capital" noted that:-

"Equitable has a high exposure to guaranteed annuity options. It had to establish reserves for GAOs in excess of £1.5bn in 1998 and it is arguable that a higher reserve should have been set. Approximately half the reserve is covered by a reinsurance arrangement. It is dependent on the reinsurance to be able to demonstrate a reasonably healthy level of free assets. Also potential risk that Equitable could need to pay compensation to GAO policyholders if it loses the current court case".

### **Regulatory failure**

**5.24 It should have been clear by the late 1980s/early 1990s, when long-term gilt yields and annuity rates were falling, that The Equitable was not capable of withstanding falling interest rates because of its excessive bonuses and onerous guarantees. In view of its weak financial position it was improper for The Equitable to be issuing personal pension policies without GAOs. The regulator knew, or should have known, what was going on and taken appropriate action possibly to stop it taking on new personal pension plan business which did not have GAOs; possibly for the guarantees to be written out of existing policies; and at very least to commence reserving for the guarantees, and charging for them either from the premiums paid or by reducing the bonuses paid to policyholders with GAOs. It did nothing.**

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<sup>46</sup> The Government Actuary wrote another letter on 22 December 1999 clarifying the interpretation that Appointed Actuaries could put on reducing liabilities by assuming that some policyholders might not take up their GAOs. He commented "I would like to clarify that I was referring here to the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent "a few percentage points".

**5.25** The Equitable recognised the problem of GAOs when it became a reality in 1993 – there is no excuse for GAD/ID taking a further five years before approaching The Equitable about its policy for reserving for GAOs. GAD explained that The Equitable’s “valuation methodology in their returns was somewhat obscure and required the reader to pick up comments in three quite separate parts of the return” – this was no excuse; the government prescribed the format of the return. GAD eventually commented *“at first sight the solvency position looked reasonable, but the available assets of £3,861m to cover RMM of £1,114m included a future profits implicit item of £925m, disregarded the liability to repay a subordinated loan of £346m and benefited from a reduction of almost £1.1bn in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511m, “a less satisfactory picture for this large fund” (4.59.39).*

**5.26** Allowing The Equitable to meet “approximately half of the reserve” requirement not with the “robust” reinsurance called for, but with a device which was merely regulatory arbitrage that was valued for solvency margin purposes at £1.1bn but in reality had negligible substance, was a dismal performance. This regulatory flabbiness was compounded by accepting the reinsurance arrangement for regulatory purposes *before* it was signed. Baird rightly observed “we are concerned that reliance should be placed by the regulator on an agreement which was material to Equitable Life’s ability to comply with its statutory solvency requirement when that agreement had not been executed by both parties” (6.10.2). Subsequently - perhaps better late than never - “The FSA has already announced that an important part of the project led by FSA managing director John Tiner on the future of insurance regulation will be focused on financial reinsurance, with a view to eradicating market practices that are no more than window dressing”<sup>47</sup>.

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<sup>47</sup>FSA statement on reinsurance agreements at Equitable Life, 26 November 2001. The FSA’s CP144 states:-

“We are proposing high-level guidance, setting broad standards, rather than detailed requirements that might prove unsuitable or inflexible for managing or regulating evolving practices in this area. This emphasises the importance of management satisfying itself about the purpose and effect of any financial engineering and the credit taken for regulatory solvency purposes.

Proper account should also be taken of the credit and legal risk inherent in many of these arrangements. This is reflected in the proposed guidance. We are also now re-consulting in CP143 on requirements relating to reinsurance concentration, which would come into effect in the Integrated Prudential sourcebook (PSB) in 2004.

We are also proposing clearer and more directly comparable presentation of information on financial engineering in the regulatory returns. This should help informed users of the returns to understand the effect of these arrangements and make better-informed comparisons for consumers between the financial condition of different insurance firms. The key changes proposed are:

**5.27 The episode we have described was one of technical ineptitude, secrecy, dilatory analysis, bureaucratic inertia, and a preference for “a low profile approach” in handling The Equitable. Despite repeated expressions of concern for “policyholders’ reasonable expectations” and of concern at the financial weakness of The Equitable, when The Equitable threatened a judicial review the regulator was reluctant to confront it and fight a corner for the benefit of policyholders. Although the regulatory authorities may have complied with the letter of the law, they bent over backwards in their judgements to accommodate The Equitable’s difficulties and avoid any public exposure – until it was too late. It is not difficult to imagine that some of the minutes recorded were written “for the file” to cover backs. The episode is one of institutional flabbiness.**

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\* for life companies and directive friendly societies, clearer presentation of the effects of financial engineering on the financial condition of both the firm as a whole and individual with-profits funds; and  
\* for non-life business, additional regulatory reporting of reinsurance arrangements.”

## 6. ALLOWING THE EQUITABLE TO REMAIN OPEN AFTER THE HOUSE OF LORDS DECISION

6.1 Commenting in June 1999 on the prospects for the outcome of the first court case on the GAO, the General Counsel's Division of the FSA advised IFSD and GAD that "...make no mistake. This is a very high risk for The Equitable. You can never predict legal outcomes" (4.31.1). Prescient words indeed.

6.2 On 18 July 2000, immediately prior to the HL decision (which was on 20 July 2000), there was a meeting between the FSA and The Equitable where "Equitable Life told IFSD that it would need to find the assets for funding the additional benefits from its own resources. Equitable Life proposed to announce immediately that it would seek a partner if this third scenario occurred. Equitable Life was keen to avoid any precipitous action from the FSA in the light of this adverse judgement. Mainly because this could have a detrimental effect on the value of the business, for example stopping the company writing new business could lead to a reduction in the field force and this was a valuable asset for the Society"<sup>48</sup> (4.55.10).

6.3 In response, IFSD indicated that it would not "rush to take remedial action in these circumstances and understood the importance of maintaining the value of the society...The FSA would, however, need to be convinced that there was a prospect of a suitable buyer being found quickly. This approach was based on IFSD's view that there was no reason to take any hasty regulatory action in circumstances where a solvent firm was seeking to put itself up for sale and any such action would be carefully considered, including the impact of such action on the interests of policyholders" (4.55.11). *Baird observed that "There is no documentary evidence that the FSA analysed the consequences, at this stage of the Equitable Life failing to find a buyer or requested information from Equitable Life on this "worst case" scenario" (4.60.1).*

6.4 Following the HL decision The Equitable put itself up for sale, and undertook a vigorous marketing campaign to attract new policyholders, and through September and October 2000 undertook a massive multi million pound advertising campaign that made no reference to the facts that it was for sale and was vulnerable.

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<sup>48</sup> Note that there is a story to be told about how valuable the sales force really was. In large measure The Equitable sold on its (then) reputation and many of the sales force were in fact no more than expensive order takers. What is certain is that retaining the sales force cost the members dearly in "six figure handcuffs" paid to retain them. There is a question to be answered about the extent to which the Board's concern for The Equitable's staff, rather than for its members, drove the generous provisions made for the staff and the deal with The Halifax.

6.5 There were various meetings and minutes and analysis of The Equitable's solvency. On 22 September 2000 GAD referred to The Equitable's solvency margin as "thin" (4.59.20), then on 17 October noted that a 15% fall in equities (which corresponded to the FTSE 100 index falling to around 5700) would leave the required minimum margin uncovered. GAD wrote a note following a meeting on 3 November 2000 observing that:-

*"With the recent cut in bonus rates...new policyholders should not have to meet any of the cost of GAOs, as indeed is likely to be their expectation. However, they will be joining a weak fund"* (4.59.27).

6.6 One by one the prospective bidders dropped out. Baird reports that one bidder informed the FSA on 31 October 2000 that (4.60.8):-

*"the more work they do in the data room the more they become convinced that the scale of the shortfall in The Equitable's funds is greater than The Equitable Life themselves estimate. Moreover they are concerned that the wording of The Equitable's policies would allow policyholders with guaranteed annuity options to increase the scale of their contributions (and hence the scale of the GAO liability) to the detriment of other policyholders in the fund".*

6.7 On 6 November another bidder asked about the regulator's attitude to financial reinsurance and, according to the note of the meeting, was told that **"the regulator did not support such arrangements which take advantage of regulatory arbitrage" (which he had recently allowed The Equitable to indulge in)**. The bidder pointed out that Equitable Life's GAO reinsurance agreement fell into this category. The bidder also asked the FSA to explain why in its resilience reserve Equitable Life was able to include a Zillmer adjustment which effectively added 1/2 % to the investment return. The bidder informed Howard Davies [the chairman of the FSA] that (4.60.12):-

*"They had reached the view that The Equitable's financial position was considerably worse than they had first thought. The hole was significantly larger than they had expected...And he said his main motive in telling me this was to alert me to the fact that The Equitable's position might be rather more doubtful than we had been lead to believe".*

6.8 On 17 November 2000, IFSD contacted IBD regarding a query from one of the potential bidders. If the bidder acquired The Equitable, it would close the with-profits fund to new business. Existing policyholders would be able to make additional payments to top-up their existing policies, which was likely to be an attractive option to GAO policyholders who might seek to pay as much as possible. IFSD commented:-

*"This is expected to shift The Equitable GAO liability significantly upwards although, according to [the bidder], a figure cannot be put on this because there are too many unknown variables in the calculation. As things currently stand this means that other policyholders in*

The Equitable fund would have to meet these additional GAO costs. *Therefore any additional payments to policies made by with-profits policyholders who do not have a GAO are likely to end up subsidising those who do have GAOs on their policies.* The question that [the bidder is] asking is whether this would be regarded by FSA as mis-selling to those policyholders who do to have GAOs” (5.31.1).

6.9 On 24 November 2000 GAD *finally* submitted its detailed scrutiny report on The Equitable’s 1999 regulatory returns using the new “risk based approach” to the regulation of life companies which the FSA was adopting. “GAD assessed the Society was exposed to a number of risks – principally reserve risks (there were questions about adequacy of the reserving approach used in a number of places in the report) and asset risk (it would be particularly vulnerable to a fall in the equity market). The scrutiny report stated that, as far as capital risk was concerned, ***at first sight the solvency position looked reasonable, but the available assets of £3,861m to cover RMM of £1,114m included a future profits implicit item of £925m, disregarded the liability to repay a subordinated loan of £346m<sup>49</sup> and benefited from a reduction of almost £1.1bn in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511m, a less satisfactory picture for this large fund***” (4.59.39).

6.10 GAD went on to observe in relation to reserve risks (4.59.42):-

“In the resilience scenario, the Society effectively takes credit for an additional ½% p.a. on the investment return. This appears to be justified as a ‘Zillmer’ adjustment to enable the Society to recoup unrelieved acquisition expenses. We are questioning this also.

The Society utilises a reinsurance treaty with Irish European which provides protection to the Society should more than 60% (formerly 25%) of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options be taken in guaranteed form. This is not wholly satisfactory from a regulatory perspective as it relies on regulatory arbitrage to achieve the desired result and would not be available in the event of insolvency. It removes over £1bn of liabilities from Equitable’s balance sheet”.

<sup>49</sup> Note that the loan does not count as a liability as long as it does not exceed 50% of a company’s RMM. As The Equitable shrinks, so does the RMM, and it is now trending to the point where it will be less than twice the size of the loan. After that point more and more of the loan will have to be accounted for as a liability in The Equitable’s solvency return as follows:-

Year	Actual and forecast RMM	Loan amount (£m)	Cover (multiple)	Loan amount to be counted as liability (£m)
2000	1, 221	346	3.5	0
2001	917	346	2.7	0
2002(f)	700	346	2.0	0
2003(f)	600	346	1.7	46
2004(f)	500	346	1.4	96

Source: An Evaluation of the Financial Position of Equitable Life for The Equitable Members’ Action Group, December 2002, Cazalet Consulting, [www.emag.org.uk](http://www.emag.org.uk).

6.11 Under the heading “Asset risk” GAD noted (4.59.43):-

“The Society is exposed to falls in the equity market. A sensitivity matrix supplied by the Society to FSA on 09.10.2000 shows the Society would be unable to cover its RMM if the FTSE-100 Index fell to around 5750 (a fall of 15% from end-August levels), though they are not particularly sensitive to movements in fixed interest yields”.

6.12 Under the heading “Strategy risk” GAD noted (4.59.44):-

“Without capital support from a prospective purchaser, the Society will be unable to reinstate the 7 month bonus foregone this year on the accumulating with profits pension business. There are PRE issues here for both GAR and non-GAR policyholders. Indeed, the related question of whether the Society should be continuing to sell non-GAR policies in the same fund as that where the GAR policies reside could be considered to be an environment risk.”

6.13 According to Baird (4.55.20/21) “when asked in interview whether Equitable Life should have been allowed to continue to write business after the House of Lords’ judgement, Howard Davies, the chairman of the FSA, told us:-

**“we thought that it was likely to produce the best outcome for policyholders, in that closing it to new business at the time would have significantly reduced the value of the company and would have significantly reduced the likelihood of a successful sale, which filled the hole”.**

6.14 He also stated that **“...the issue of closure did not seem to be a very likely option to address. I cannot say that there was a lengthy consideration of this, but given the promptness of Equitable’s response to put themselves up for sale, that, we felt, sort of held the position...I think if they had shilly shallied about the future, we would have had time to consider the options much more carefully at that time. But we didn’t really”.**

6.15 The Baird Report made the following criticisms about the FSA’s performance following the HL decision:-

- “During the Review Period, GAD was aware of the existence of entitlements in GAO policies to pay additional premiums (or “top-up” the polices), which themselves would attract the GAO. However, the prudential regulator did not question the reserving basis for these despite information received from Equitable Life in response to the GAD survey in 1998 that such entitlements were available. The issue of exposure to top-ups was considered further at a meeting in November 1998, in a telephone conversation between GAD and the Appointed Actuary on 29 January 1999 and later in October and November 1999 in the context of a question from IBD regarding the number of top-ups to GAO policies. *Further, neither IFSD nor GAD appear to have appreciated the significance of the fact that exposure could neither be reliably quantified or capped.*

*Had IFSD or GAD identified this issue sooner, it might have heightened their awareness of the possibility that Equitable Life’s liability to GAO policyholders might be significantly increased*

*by top-ups after the House of Lords’ judgement and they might have recognised a potentially significant obstacle to the sale of the Equitable” (6.10.1/2).*

- considering the operation of the Insurance Supervisory Committee (ISC), Baird observed (6.11.1/2/3/4):-

“Shortly after the House of Lords hearing and before the judgement, The Equitable requested a Section 68 Order permitting a proportion of future profits to be counted towards solvency in the regulatory returns for 2000. Prudential Guidance issued in 1984 states that such Section 68 concessions “will be readily available” and it is our understanding that it had been the practice to grant them, provided that the requirements in the regulations had been satisfied.

A paper was prepared by IFSD, after the House of Lords’ judgement, incorporating advice from GAD, to the ISC inviting them to approve a recommendation to the Treasury to grant approval of this item. However, this was a short paper and only summarily dealt with the wider background. It did not consider the cumulative effect that this implicit item, the subordinated loan and the reinsurance agreement had on alleviating The Equitable’s weak regulatory capital base and the impact this in turn may have on its ability to meet the reasonable expectations of potential policyholders.

The paper did not mention that the summary figures for solvency provided by The Equitable were based on an older, weaker resilience test than the one GAD considered appropriate for current conditions. Although the adoption of any particular resilience test is not compulsory, it is notable that, had the normal test been used, The Equitable would have failed to meet its RMM without the implicit item requested. Also the paper did not mention that GAD’s advice had been given before the House of Lords’ judgement even though the decision was being taken after that judgement. Without meeting (although with an opportunity for members to comment) the ISC approved the Order...we consider that the process leading up to the decision was flawed, because important issues were not highlighted or explained to the ISC”.

*This was extraordinarily sloppy performance by IFSD, if not also by the ISC.*

- “We would have expected IFSD to have adopted a more sceptical approach to Equitable Life’s assertions about its prospects of success in the case and to have been more proactive in considering the implications of the possible final outcome (6.15.7)
- “IFSD’s response was to ‘reassure’ Equitable Life that it would not rush to take remedial action in these circumstances although it would need to be convinced that a suitable buyer for the Society could be found quickly. It is not clear that the impact of this stance on policyholders, existing and potential, was given full consideration either ahead of this reassurance or immediately afterwards” (6.16.1).
- “We believe that closer and more informed scrutiny, at an earlier stage, of the financial implications of the possible outcomes of the Court case, which had been foreseen in the scenario planning, would have given the regulator more time to reflect on how to react appropriately to any courses of action proposed or taken by The Equitable in response to any ruling of the Court. It was recognised that this could either have a materially adverse impact on The Equitable or leave the policyholders’ reasonable expectations issue to be resolved by the regulator”

## **Regulatory failure**

**6.16 There were two reasons why The Equitable was not saleable:-**

- **it was chronically financially weak with its solvency supported by financial engineering. To repeat again “*at first sight the solvency position looked reasonable, but the available assets of £3,861m to cover RMM of £1,114m included a future profits implicit item of £925m, disregarded the liability to repay a subordinated loan of £346m and benefited from a reduction of almost £1.1bn in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511m, a less satisfactory picture for this large fund*” (4.59.39). In fact because of its quasi-Zillmerising, The Equitable was weaker than GAD assessed**
- **the policies with GAOs were subject to top-up and so represented an unknown liability**

**6.17 We consider that the consequences of Davies’ casual attitude towards allowing The Equitable to remain open was a major regulatory failure, which had unfortunate consequences for the many policyholders who invested in The Equitable after the HL decision. Davies’ decision not only allowed prospective policyholders to join a fund which was weak before the HL decision and was further weakened by the decision, but the FSA was undermining their reasonable expectations. People were essentially being allowed to invest their money on the prospectus that if The Equitable can find a buyer who will:-**

- **remove the liability of the GAOs (which can increase as policyholders with GAOs put more money into their policies)**
- **resolve the consequences of past over-declaration of total bonuses**

**then you may have reasonable expectations. If not, sorry you are in a mess.**

**6.18 The FSA through GAD should have known more than enough about The Equitable’s financial situation to be able to have worked out its limited prospects for sale and the implications for new policyholders’ reasonable expectations, and to have acted accordingly by closing the fund until it was sold. The FSA might – perhaps should – have been able to work out that The Equitable was better placed to effect a GAO compromise than a purchaser. It could plead poverty, whereas a purchaser with a deep pocket could only pay-up something approaching the full value of the options, which is why none of them volunteered. The convenience of the sales force should never have entered into the calculation, and the claims that the sales force was a valuable asset should have been treated with scepticism. Once again the FSA adopted the traditional regulatory approach of bending over backwards to accommodate the wishes of The Equitable.**

**6.19** While prospective bidders worked out quickly The Equitable’s financial situation, it appeared to take a long time for the penny to drop within the FSA. This was perhaps a consequence of the tardy and inadequate analysis of The Equitable’s circumstances by GAD, which failed to recognise the significance of the top-up provision and was very slow in analysing the 1999 solvency return (completing it on 24 November) to identify just how weak The Equitable was. As Baird observed “There is no documentary evidence that the FSA analysed the consequences, at this stage of the Equitable Life failing to find a buyer or requested information from Equitable Life on this “worst case” scenario” (4.60.1).

**6.20** The episode brings out in extreme form the inherent conflict in the FSA’s objectives between preserving market confidence (however undeserved), which appears to have been its overriding priority and will generally prevail – and definitely did in this case – versus that of protecting consumers, which might cause embarrassment. *We recommend that responsibility for conduct of business regulation is transferred from the FSA and set up as an independent agency.*

## 7. THE FSA'S FAILURE TO TAKE ACTION TO MITIGATE THE CONSEQUENCES OF THE HL DECISION FOR POLICYHOLDERS WITHOUT GAOS

7.1 We consider that the FSA was at fault in not considering what might be done legislatively to mitigate the consequences for the life assurance industry in general, and The Equitable in particular, of what was clearly a highly problematic decision by the HL<sup>50</sup>. The ruling was manifestly inequitable to policyholders who did not have GAOs, and who were ex-post forced to subsidise policyholders with GAOs. Some observers believe that the case was not well put, which may be because the barrister who was originally going to lead for The Equitable withdrew shortly before the court hearing. We understand that one of the Lords of Appeal in Ordinary who heard the appeal has observed extra-judicially that “if the case had been put differently and we had known the true facts, the outcome might have been different”.

7.2 Given what we now know about the skeletons in The Equitable's cupboard, and the bareness of that cupboard for which the then Board was responsible, that Board had an interest of its own as to how the case was presented. Their interest diverged significantly from the interest of the non-GAO policyholders, and that may account for the fact that their Lordships appear to have been left with the wholly erroneous impression that GAO policyholders could be treated as generously as they claimed without disappointing the legitimate expectations of non-GAO policyholders. It was thus clearly unsatisfactory for The Equitable, i.e. the Board, to purport to represent the non-GAO policyholders. It is our understanding not only that the original representation order that permitted them to do so was made by the Chancery Court in ignorance of the conflict of interest, but also that that representation was not revisited when The Equitable agreed, when the case reached the HL, that the “ring fencing issue” should be decided.

7.3 It is difficult to believe that any court that had understood the basic economics of the position could have concluded that, in a mutual which was intended to operate equitably as between its members, one class of policyholders should be expected, without consideration, to shoulder a major systemic risk for the benefit of another class of policyholders. We suspect that the HL's failure to

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<sup>50</sup> For a discussion of possible legal flaws see “Equitable Life Assurance Society v. Hyman - the extrinsic facts issue, Alan Berg, The Journal of Business Law, September 2002. The case hinged on the extent of the director's discretion under article 65 of The Equitable's Memorandum and Articles of Association. Berg argues that:-

- Lord Steyn's speech (which was the leading speech) was inconsistent with an earlier decision regarding the relative significance of terms in contracts vis-à-vis a company's memorandum and articles of association which had been decided in a Court of Appeal case, and to which he was party
- “Lord Cooke failed to take account of the fact that members with non-GAO policies “might not” (most certainly did not) understand from the information available to *them* that the directors' powers under article 65 could be exercised so as to place on *them* entirely to their detriment, a major part of the cost of meeting the guarantees of the policies with GAOs”

appreciate this basic consideration was at least partly attributable to the fact that The Equitable appears to have withheld from HL any indication that, without ring-fencing, the solution advocated on behalf of the GAO policyholders would have disastrous practical implications. If we are right about that, then the conflict of interest, to which we have referred, probably contributed to the course of the hearing. Especially bearing in mind that the HL – with the agreement of the parties – in effect acted as the court of first instance in relation to the newly raised issue of ring-fencing, one also asks how it can have happened that the lawyers advising The Equitable, i.e. advising the Board, failed to appreciate that there was a conflict of interest and failed so to advise the Board? Unless, of course, such advice was given and disregarded. With the benefit of hindsight it seems inconceivable that the lawyers agreed to proceed to act for both the non-GAOs and the Board, given the obvious conflict.

7.4 It is clear from the letter of 18 December 1998 from Mr. Martin Roberts, Director, Insurance in The Treasury titled “Guaranteed Annuity Option Costs and Policyholders’ Reasonable Expectations”, addressed to the managing directors of life assurance companies, that “in the Treasury’s considered view” the differential bonus approach (as adopted by The Equitable) appeared to be acceptable (“without prejudice to any decision of the courts that may affect it”). It was upon that understanding that The Equitable reserved only for the guaranteed portion of policy values. The HL then changed the goal posts, and this had a major impact on The Equitable and other life assurers. In mutual funds the ruling impacted significantly on the reasonable expectations of policyholders who did not have GAOs, and who were now called on to fund policyholders who had them.

7.5 The background to the HL decision was known to, or readily ascertainable by, the FSA<sup>51</sup>. Given its consequences, the FSA should have looked for ways of mitigating the consequences. Not only did it not do that, but it accepted decisions by The Equitable which entrenched the consequences of the HL decision:-

- it acquiesced in The Equitable crudely imposing a policy reduction of 16% on 16 July 2001 across all policyholders based on their total policy value. It would obviously have been more equitable to have imposed the cut proportional to the value of bonuses accrued since 1988. This would have borne more heavily on policyholders who had been longest with The Equitable – notably those with policies incorporating GAOs – and less on more recent policyholders who did not have GAOs. (EMAG prepared a note for the chairman on this point and discussed it at a meeting on 7 March 2001, four months before the cut)

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<sup>51</sup>If, and to the extent that it was not known to them, then the FSA should have vigorously investigated it as the disastrous consequences of the HL decision became apparent.

- subsequently, the FSA endorsed The Equitable’s proposed compromise scheme which deliberately obfuscated, then discounted, the advice of an opinion by leading counsel Nicholas Warren QC and Thomas Lowe that policyholders without a GAO had a strong case for mis-selling. The FSA was party to the rush to push the majority of the members of The Equitable to sign up to a flawed compromise, led on by insinuations that if the compromise were not agreed The Equitable would collapse, and by the suggestion (which has not been realised) that, if it were agreed, the fund would return to stability

7.6 Following the compromise, in the face of threats of legal action, the FSA required The Equitable to commission reports on the issue. It commissioned a joint opinion from Christopher Carr QC and Gabriel Moss QC on “Remedies for Mis-Selling”. The opinion concluded that (para 48) “a former non-GAO policyholder with a cause of action based in negligent mis-representation or non-disclosure is entitled to recover by way of damages a sum equal to the loss of return that he has suffered as a result of the need to fund GAO liabilities”, and that (para 64) “the measure of damages should, in our opinion, be the lower of:-

- (i) the sum needed to bring the return of a former non-GAO policyholder up to the level of return he would have enjoyed with a comparable group of life houses
- (ii) the loss of return suffered by a former non-GAO policyholder as a result of the Society’s inability to satisfy the rights of GAO policyholders through the application of differential bonuses or ring-fencing

**We consider that this report was noteworthy for what it did not address. Namely it restricted itself to negligent mis-representation or non-disclosure, and did not address the issue of possible fraudulent misrepresentation. As The Equitable will only consider claims based on this opinion, probably the claims of some policyholders are being ignored.**

The Equitable also commissioned a report by actuaries B&W Deloitte to assess “By how much many Non-GAR policyholder benefits have been reduced to meet the cost associated with paying Guaranteed Annuity Rates (GAR) on GAR policies”<sup>52</sup>. The report concluded that such policyholders had lost 5% of their policy value. (The report was suppressed for several months, and may have been modified to coordinate with the legal opinion).

7.7 *Those who did not go along with the compromise that was endorsed by the FSA and withdrew their funds appear likely to end up better off than those who remained. In view of its*

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<sup>52</sup> Non-GAR Mis-Selling Claims: Independent Actuarial Review, Prepared for The Equitable Life Assurance Society, September 2002, B&W Deloitte.

*unequivocal active endorsement of the compromise, this should be embarrassing to the FSA since it is supposed to protect the policyholders' reasonable expectations.*

**Regulatory failure**

**7.8 We consider the FSA's failure to mitigate the consequences of the HL decision was a significant regulatory failure.**

## 8. FAILURE TO ENSURE THAT POLICYHOLDERS AND PROSPECTIVE POLICYHOLDERS WERE PROPERLY INFORMED ABOUT THE EQUITABLE'S FINANCIAL CIRCUMSTANCES

8.1 As we have explained, the HL decision was the catalyst, but not the main cause of the difficulties of The Equitable. The main problems which led to the savage reductions in policy values and to the destruction of policyholders' reasonable expectations were:-

- over-declaring total bonuses so that policy values exceeded asset values
- the financially weak position of the with-profits fund due to granting too generous a level of guaranteed bonuses
- the failure to reserve and charge for GAOs

8.2 There was no way in which a (prospective) policyholder who was not a life assurance actuary or an accountant specialising in life assurance – i.e. nearly *all* policyholders - would have been able to ascertain the financial circumstance of The Equitable. And even specialists would have required extensive and detailed analysis to make sense of:-

- The Equitable's accounts, which were not as clearly presented as they could – and should - have been<sup>53</sup> (*and remain so*). The accounts require significant recasting before it is possible to understand them and to identify the performance of the with-profit fund
- The Equitable's solvency returns, which ran to 329 pages in 2000. As the FSA has observed in general of solvency returns they “have become voluminous and overly complex, even to expert users”.<sup>54</sup> The Baird Report flagged up a number of occasions obscurities in The Equitable's returns which caused difficulties for GAD

8.3 To add to the difficulties the two documents are not consistent in their treatment of contractual liabilities (and there is no requirement to highlight differences between the two)<sup>55</sup>, and neither provide information on the total values of policies including non-guaranteed bonuses. The FSA's Integrated Prudential Source book, (p97, June 2001), states:-

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<sup>53</sup>The report prepared by Burgess Hodgson “A Reinterpretation and critique of the Society's recent Interim Accounts” prepared a critique of The Equitable's interim accounts for the period ending 30/6/2002 and made adjustments to make them more comprehensible (see [www.emag.org.uk](http://www.emag.org.uk)).

<sup>54</sup> Para 4.2. The new regulatory reporting requirement, Discussion Paper 12, Financial Services Authority, May 2002.

<sup>55</sup> An insurance company's annual accounts are prepared under the Companies Act 1985. Up to 1995, there was not necessarily any distinction between the actuarial values of the liabilities shown in the Regulatory Returns and in the Statutory Accounts since the latter were not required to be prepared on a “true and fair” basis but “in accordance with the requirements for insurance companies”. The Companies Act (Insurance Companies Accounts) Regulations 1993 changed this by requiring that the accounts of insurance companies in respect of financial years commencing after 23 December 1994 should be prepared on a “true and fair” basis. As a result of this, the statutory valuation basis for liabilities required for prudential purposes (including, as it does, significant margins) is no longer an automatic choice for the value placed on the long-term business provisions required by the Companies Act.

“We consider that quantification of the provisions for terminal bonuses and its recognition as an on-balance sheet liability would help the FSA, policyholders, and the firm’s own management in determining whether adequate resources are being maintained to meet policyholders’ expectations”<sup>56</sup>.

8.4 We understand the requirement to report the value of terminal bonuses is not due for implementation until 2004. *This is a dilatory performance by the FSA, which can surely persuade the Department of Trade and Industry to use its powers under the Insurance Companies (Accounts and Statements) Regulations 1996 to prescribe the information.*

8.5 Since The Equitable sold almost exclusively through a direct sales force, independent financial advisers were not particularly interested in its financial performance and so it was subject to little, if any, informed analysis in the public domain and to the checks and balances that can apply to life companies that sell through independent financial advisers. Consequently the overwhelming majority of policyholders or prospective policyholders or their advisers would have no source of outside advice to look to. Furthermore, since very few policyholders or prospective policyholders would have known that there were such things as solvency returns, then to the extent that they tried to look at The Equitable’s financial performance they would have relied on the Annual Report and Accounts, which the salespeople provided. They would not only have come across the presentational difficulties mentioned above, there would have been:-

- no statement that the total value of policies was above the value of assets
- no record of a provision of £1.6bn for GAOs in 1998 and 1999. The claim by the current board of The Equitable against the former Appointed Actuary<sup>57</sup> (and similarly also against the former auditors) argues (paras 96 and 97) that “the additional technical provisions in respect of GAOs ought to have been included in the Society’s statutory accounts for 1997 to 1999. Those provisions ought to have been included even if the directors had been correct in their assumption that they could award differential terminal bonuses”. *Why, when the regulator required a £1.6bn provision to be made against the guarantees, did the regulator not also require Equitable and its auditors to inform policyholders (present and prospective) of the risks to the with-profits fund? This failure for the 1999 Accounts which were published on 23 March 2000 breached the FSA’s prospective statutory duty under S.4(2)(a) of the Financial Services and Markets Act to promote “awareness of the benefits and risks associated with different kinds of investment”*
- no reasoned statement of the solvency position explaining by way of a summary how the margin was calculated<sup>58</sup>

<sup>56</sup> Perhaps if the FSA had acted swiftly on this issue, some Standard Life with-profits policyholders who exited last year would have received less, and the cut for those who stayed would have been less.

<sup>57</sup> Op cit.

<sup>58</sup> The With-Profits Guide, 31 August 1999, published by The Equitable provided a summary statement of the solvency margin, but under the heading “admissible assets” neither split out nor referred to the implicit profits items, the subordinated loan, nor the reinsurance contract.

- no explanation of the significance of either the subordinated loan of £346m (which surely should have merited an explanation in the Annual Report and Accounts), nor of the reinsurance contract (which did not appear in the accounts until 2000, after the difficulties were apparent)

And there is no way that a (prospective) policyholder would have been aware of the concerns of the regulatory authority about The Equitable because those concerns were kept within “smoke filled rooms” – policyholders were left in the dark.

8.6 The FSA has recently proposed that by the end of 2003, life offices should produce a document called “Principles and Practices of Financial Management”. Directors would have to certify annually that the with-profits business had been run in accordance with the document. If the FSA have found it necessary to consult on tightening up the reporting process to ensure that another collapse like the Equitable does not occur, then that is further evidence that the FSA regards the existing reporting to be inadequate.

8.7 The Corley Report of the Institute and Faculty of Actuaries<sup>59</sup> commented “Nevertheless it does seem to us clear that unambiguous reporting of the financial condition of life insurance companies, including informative reporting on risks and uncertainties of the business, would help to ensure that incipient problems are brought to light sufficiently early for appropriate action to be taken. Anything that the regulators and those responsible for Companies Acts can do to eliminate the present confusion would be welcome”. This comment illustrates the systemic failure of competence by the actuarial profession which pretentiously claims to be “making financial sense of the future”. It has been incapable of making sense of the past and current times, let alone the future. As a former President of the Institute of Actuaries fatuously observed “Actuaries should preserve a certain amount of mystery, and avoid absolute clarity”<sup>60</sup>. He might more appropriately have commented “What we try to deal with is complicated; we do not really understand it all; so it is best to wrap up our trade in obscurity and hope no-one notices”. *The actuarial profession in general has a great deal to answer for the demise of The Equitable.*

8.8 According to Baird (2.9.1.) “The IFSD described to us two important elements of the prudential regulatory regime:-

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<sup>59</sup> The Report of the Corley Committee of Inquiry regarding The Equitable Life Assurance Society, The Faculty of Actuaries and the Institute of Actuaries, September, 2001.

<sup>60</sup> Duncan Ferguson, April 1997.

“The whole essence of regulation was freedom with disclosure. That the substantial amount of information put in the public domain, by contrast to the banking world, allowed the regulator, the analysts, everyone out there to look and see the position...”

This complacent assertion fundamentally confuses the different requirements consumers have for information about the stewardship of their money by a bank and by life assurance companies; and it contradicts the recognition by the FSA that the present reporting requirements of life offices “may not provide readily accessible information to policyholders and other users”. “*May not*” should be replaced by “*do not*”.

### **Regulatory failure**

**8.9 We regard the inadequate provision of information to (prospective) policyholders as a significant failure by the regulatory authorities, which had all the powers necessary to prescribe the format of both the accounts and of the solvency return. They could – and should – long ago have been able to reach the conclusion of the Sandler Report<sup>61</sup> that (para 10.111): “Consumers cannot assess the quality or the true price of with-profits policies, since they cannot identify the effects on their payouts of:-**

- **operating efficiency**
- **investment performance**
- **smoothing policy”**

**8.10 Likewise, they should have been able to reach Sandler’s recommendation that with-profit funds should report separately a with-profits account, a smoothing account, and an account for supporting capital including the “orphan estate”, if any. *Furthermore, we recommend that non-profit business and other business activities should be accounted for and reported separately in the Annual Report and Accounts.***

**8.11 All the brain power associated with the regulatory authorities should have been able to grasp the obvious many years ago. As it was the regulators continued with their paternalistic approach to the consumers of life assurance of not ensuring that they receive adequate information to allow people to judge for themselves. At the same time they failed in their paternalistic duty to regulate effectively on their behalf. We generally account for what we think is important – the regulatory authorities obviously did not regard transparency for policyholders as important.**

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<sup>61</sup>Medium and Long-term Retail Savings in the UK A Review, July 2002, HM Treasury.

## 9. THE COMPLETE FAILURE OF CONDUCT OF BUSINESS REGULATION

9.1 Two themes run through chapter 5 of the Baird Report on the conduct of business regulation of The Equitable from June 1998, when the FSA in practice took over responsibility for it. The first is that the FSA had a marked disinclination to intervene, even when it had identified an objective need to do so, with the result that it is far from clear that the existence of the regulatory regime made any practical difference to the conduct – and misconduct – of the affairs of The Equitable. Was the result simply of ineptitude and inertia, or was it motivated by a desire not to “rock the boat” of a life company that was regarded as providing a model for the future?

9.2 The second is that there was little or no coordination between the part of the FSA responsible for prudential regulation (IFSD) and the part responsible for conduct of business regulation (IBD). The events described in this chapter and the quotations from Baird adequately convey the sense of bureaucratic inertia and a preference for keeping well below any possible parapet that might be in sight.

9.3 In addition to the events in Baird, we point out that there appeared to be a complete failure by either the PIA and then the FSA to do anything:-

- to stop The Equitable (and doubtless other companies) from selling draw-down policies to people who had only modest values in their funds. Draw-down policies are not suitable for people who have a fund of less than £200-250,000, yet they were being sold to people with pension funds of less than £100,000. In the 2001 Accounts The Equitable allowed for provisions of £80m for mis-selling of draw-down schemes
- to highlight the risks of with-profits annuities. Not only can they go down as well as up, but a weak with-profits fund like The Equitable, with no cushion of an orphan estate and with the “negative smoothing fund” which the regulatory authorities allowed it to run, was very vulnerable to a downturn in the stock market. The consequence of this failure is that some 50,000 elderly pensioners who have bought with-profits annuities will be put into straightened circumstances by the cuts in their pensions which began to hit them last month

### Passive regulation

9.4 A memorandum dated 20 January 1999, considering what action IBD was taking in relation to GAOs, noted that “as the subject was attracting increased attention in the media, it seemed sensible to consider the issues raised by Equitable’s treatment of GAOs in a bit more detail to see whether there was anything that IBD should be doing in order to fulfil its regulatory obligations, *or at least to justify its stance of non-involvement*” (5.8.5). Another memorandum asked “Is there at least enough for a meeting” (5.8.13). A memorandum by the IBD dated 22 March 1999 (5.9.4)

“concluded by querying whether it should be looking more closely at what Equitable Life was doing (given that it was the only company with a significant number of complaints lodged with the PIA Ombudsman). It was noted that:-

“The difficulty with taking this forward is that we would be basing any action on hearsay and reports read in the press, and not on hard evidence. However, this is a significant issue and we are probably obliged to contact Equitable Life about it”.

“It appears, however, that IBD never did contact Equitable Life in relation to any of the issues identified. We were told in interview that it was thought appropriate to wait for clarification on the legal position before applying significant supervisory resource to the situation” (5.9.5).

9.5 When IFDS responded to the IBD (about an investigation into the selling of draw-down policies by The Equitable) stating that Enforcement was going to provide it with an update, IBD further commented:-

“My general feel is that Enforcement do not have an appetite for this one. As it was not the normal style of referral – i.e. we did not pass them a visit report with rule breaches etc. – this is probably why it was not mentioned before” (5.24.2).

“An internal hand-written note dated 17 October 2000 reads:-

“Is there anything we should now be doing on this? I know we were going to about a year ago (my delay) - has the time passed?” (5.27.1)

9.6 After the HL decision The Equitable mounted an energetic marketing campaign which worried a number of members of the public and journalists, who complained. Baird sets out IBD’s handling of the issue:-

- “As for advertising, the IBD did not pay any special attention to Equitable Life’s advertising after the House of Lords’ judgement but, between the House of Lords’ judgement and the closure to new business on 8 December 2000, certain complaints were forwarded to IBD in connection with Equitable Life’s advertising” (5.30.2)
- “On 13 November 2000, IBD and IFSD were informed by Media Relations that newspapers had contacted the FSA about Equitable Life suggesting that there would need to be regulatory intervention if a buyer could not be found. The line that had been given by the FSA to the press was that, on present information, a profitable run-off was the worst that could happen and there was no disaster in the making” (5.30.10).
- “I don’t think we should show anything but disinterest [sic] in response to public enquiries – it is a matter for the company”. IFDS also approved the FSA line to be used if there was no successful bid stating. If we say anything else, we will simply be asked why we have not intervened already to protect policyholders in case a bid fails” (5.30.11).

9.7 As someone so rightly observed to Baird, “The IBD tradition is at the more passive end of the supervisory process. The nature of their supervision...is much more reactive than proactive” (2.30.2). Baird believed “that more active consideration should also have been given by IBD as to the effect on existing non-GAO policyholders or GAO policyholders making further investments in the with-profits fund by means of top-ups and the need to monitor what, if anything, The Equitable was saying to its new policyholders about this” (6.21.7). *Since IBD was scarcely considering anything, it would have been simple to achieve this objective.*

### Lack of coordination

9.8 Baird observed “There was also lack of coordination” (5.19.2) both before *and after* the FSA took over responsibility for prudential regulation between IBD and ID then between IBD and IFSD. Thus we read that:-

- “None of the information in response to the survey was passed on by ID to IBD. At that time these were separate regulatory bodies with no formal mechanism for the coordination of their respective duties. The IBD was subsequently told, in a memorandum of 3 September 1998, which referred to the GAD survey, that IBD would no doubt have an interest in the issue such as the extent to which companies are informing policyholders about the existence of a GAO at vesting” (4.9.7)
- “Following a meeting IBD was not aware of the continuing review of Equitable Life’s position or subsequent meetings between IFSD and Equitable Life” (5.26.7)
- “We have been told that the IBD was not party to any discussions as to whether Equitable Life should be permitted to continue to write new business after the House of Lords’ judgement because this was a matter essentially for the prudential regulator” (5.30.1)

### Regulatory failure

**9.9 Members of The Equitable paid for the PIA, and presumably continue paying for IBD<sup>62</sup>. But at least prior to the Compromise Agreement<sup>63</sup>. IBD achieved nothing – absolutely nothing – for the policyholders of The Equitable. Its performance was nothing short of disgraceful.**

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<sup>62</sup> The President’s Statement to members in The Equitable’s Annual Report for 1996 states that “...in each of 1995 and 1996, we paid almost £1.3m in fees to the PIA”.

<sup>63</sup> Subsequently it has acted on behalf of some groups of policyholders obtain redress for mis-selling.

## 10. THE ROOTS OF REGULATORY FAILURE

10.1 One clear reason for regulatory failure was the shortage of resources. Baird showed that the staffing level deployed for the prudential regulation of insurance companies appeared to be much lower than that deployed for banking regulation<sup>64</sup>. A second was the cultural attitude of the activity. Baird observed that (7.7) “The Review Team’s impression of the style of the prudential regulation of the long-term insurance industry inherited by the FSA, when compared with its prudential regulation of the banking industry, is that it is less intrusive and involved”. It recommended that the FSA should “be prepared to act more proactively in pursuance of its statutory objectives to ensure that the interests of customers are properly protected” (7.6). *Given the lamentable level of performance of the FSA demonstrated over the Review period, this should not be difficult to achieve.*

10.2 Based on the direct experience of the chairman of EMAG, who spent two years seconded to the civil service at a moderately senior level, power and glory in the civil service goes to those who advise ministers on policy. Many functions that are relatively routine and are not in the political limelight are performed by civil servants who wish to keep it that way both for their ministers and for themselves. Providing a safe pair of hands is the route to steady – albeit often mediocre – progress; attempting to raise issues that might get in the newspapers can be a higher career risk. We have no difficulty in imagining that ID was one such routine function – whether or not the staff preferred to enjoy a clubby atmosphere with the life assurers, it seems clear that they did not relish the prospect of a public confrontation with the oldest (and perhaps “venerated”) mutual in the world, which was favoured by judges, lawyers, accountants, and Members of Parliament.

10.3 For GAD’s part, generally technicians in the civil service, whether they be economists, architects, or actuaries, are on tap but not on top and they take a back seat. What we do not know is the extent to which ID/IFSD could in effect “instruct” GAD to undertake work (as a private party

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<sup>64</sup> “On 1 January 1999, the total number of staff involved in the prudential regulation of approximately 200 insurance companies (including the staff at GAD but excluding administration and secretarial staff) was less than 35. By way of comparison, there were approximately 135 staff (excluding administration and secretarial staff) involved in the regulation of approximately 400 authorised UK banks, building societies and UK branches of non-EU institutions” (2.23.5). Only 23 actuaries were transferred to the FSA from GAD. According to Fancyfree50 on Motley Fools posted mid September 2002 these 23 people were supposed to regulate the UK insurance industry, which is the largest in Europe. It:-

- employs 340,000 people, a third of all financial services jobs
  - contributes around £8 billion a year to UK overseas earnings
  - accounts for over 20% of investments in the stock market
  - pays out £225 million a day in pension and life insurance benefits
  - over £930 billion is invested in long-term insurance products, which is 29% of UK personal sector wealth
- This was an impossible task for 23 people; The Equitable disaster (or some other), was a disaster waiting to happen.

would instruct a consulting actuary to undertake an assignment), or whether GAD (being for much of the period we have covered in a separate government department and having a range of responsibilities other than monitoring life assurance companies) ran its own agenda. The tardy performance by GAD in completing the 1997, and more reprehensibly the 1999, scrutiny returns of The Equitable does not suggest that ID/IFSD was instructing GAD to work to what should have been an obvious priority for IFSD. Trying to get two Directorates within Whitehall to coordinate their activities can be a very difficult task even when they are in the same ministry, let alone when they are in separate ministries.

10.4 Whatever the bureaucratic arrangements, we consider that GAD bears a major responsibility for The Equitable disaster:-

- GAD failed to address the general issue of reserving GAOs in the mid 1980s
- GAD failed around the late 1980s/early 1990s to force The Equitable to address the potential risks it had taken on, but allowed it to continue writing personal pension policies which had no GAOs and were at risk of bearing the costs of policies whose GAOs came into the money on their guaranteed values. In a similar manner it failed in 1996 to protect policyholders without a GIR
- GAD's response to learning that the total face value of the policies was higher than Equitable Life's admissible assets, was that it "did not necessarily cause GAD any concern" (4.3.8)
- GAD acquiesced in the policy adopted by The Equitable during the 1990s to grow rapidly
- "GAD did not engage The Equitable until five years after the GAO issue emerged on a permanent basis. GAD accepted that it should have picked up the annuities issue earlier". It offered an excuse that The Equitable's valuation methodology in their returns was somewhat obscure and required the reader to pick up comments in three quite separate parts of the return (4.23.4). This was no excuse; the government prescribed the format of the return
- Until "alerted to the issue in late 2000" (6.9.2) GAD did not pick up the significance of a statement in The Equitable's regulatory returns that "½% p.a. of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses" (4.7.2). "The negative impact on solvency of removing the ½% was estimated by Ernst & Young to be just under £1 billion" (6.9.2)
- GAD never identified the burden on The Equitable's with-profits fund from its non-profit business
- GAD was dilatory in undertaking its scrutiny analysis. According to Baird, the dates GAD completed scrutiny reports were as follows:-

report for the year	return provided by The Equitable	completed on	period to complete (months)
1996	25/6/1997	8/12/1997	5
1997	24/6/1998	20/5/1999	11
1998	30/3/1999	20/5/1999	2
1999	26/6/2000	24/11/2000	5

- regarding the reinsurance contract, although GAD may have “always expressed discomfort with these types of regulatory arbitrage arrangements and suggested to the companies that, if possible, the regulator may well seek to limit the benefits that can be derived from these arrangements”, there is no evidence in Baird that GAD rejected The Equitable’s absurdly generous valuation for its contract
- Although “The Equitable disclosed that GAOs did apply in most contracts to increments to existing policies” (4.14.9), “GAD did not appear to have appreciated the significance of the fact that exposure [to GAOs] could neither be reliably quantified or capped. Had ...GAD identified this issue sooner, it might have heightened their awareness of the possibility that Equitable Life’s liability to GAO policyholders might be significantly increased by top-ups after the House of Lords’ judgement and they might have recognised a potentially significant obstacle to the sale of the Equitable” (6.10.1/2)
- GAD did nothing to improve the provision of information to policyholders of The Equitable. Indeed at one stage it queried whether “the existence of the options should be made known (*is this going a step too far?*)” (4.11.1)

10.5 Finally there is the question whether The Equitable was treated “leniently” from a regulatory perspective because it was the pension provider of choice for many of the “establishment”; as a non-commission based mutual it was not perceived as being “soiled” with the conflicts of interest that pervade proprietary companies selling through independent financial advisers; and it was perhaps regarded as a model for stakeholder pensions, which the government wished to promote. If a relatively low profile part of the civil service tried to draw public attention to The Equitable’s shortcomings, then it might have been sat upon from a great height.

#### 10.6 **The regulatory authority was consistently a paper tiger.**

## Annex THE LEGAL FRAMEWORK OF REGULATION

A.1 Until 1/12/2001 – which embraces the period of interest to this report - the Insurance Companies Act 1982 as modified by the Transfer of Functions Insurance Order 1997 and supplemented by the Insurance Companies Regulations 1994, provided the statutory basis for the government’s prudential powers to regulate with-profits life funds. The Financial Services Act 1986 provided the basis for conduct of business regulation. These Acts and the Regulations were repealed by the Financial Services and Markets Act 2000.

### A.2 The **Insurance Companies Act 1982**:-

- allowed the Treasury to authorise, and withdraw authorisation from, bodies undertaking insurance of various classes of long term business (s.3 and s.11)
- provided for the determination by Regulation of a “margin of solvency” (s.32) which is defined for a company as “the excess of the value of its assets over the amount of its liabilities, that value and amount being determined in accordance with any applicable valuation regulations” (s.32(5)(a)). Where a company did not meet the margin, the Treasury could require the company to submit a plan to resolve the shortfall (s.33). *(Note that the liabilities of a with-profits fund include guaranteed bonuses, but do not include “declared” or “allocated” or “granted”<sup>65</sup> terminal bonuses, which are not guaranteed. Few policyholders understood this fact, nor that the “value” of terminal bonuses were not included in the annual accounts)*
- allowed the Treasury to intervene in the affairs of company on various grounds (s.37) and “require a company to take such action as appears to him appropriate” (s.45) in order to protect “policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities and, in the case of long term business, *to fulfil the reasonable expectations of policyholders or potential policyholders*” (ss.37(2)(a) and 45)
- provided for the prescription by Regulation of the form of annual accounts (s.17(2)) and of annual and quinquennial actuarial investigations of its financial condition to assess the valuation of liabilities and of assets and to determine the excess (if any) of assets over liabilities (s.18 (5)). Furthermore “For the purposes of any investigation...the value of any assets and the amount of any liabilities shall be determined in accordance with any applicable valuation regulations” (s.18(4)). The Insurance Companies (Accounts and Statements) Regulations 1996 prescribe the information required in the annual accounts and in regulatory returns including the format of the latter
- provided for the preparation and submission to the Treasury periodically of a statement of its business by specified class in a legally prescribed form which the Treasury is free to publish (s.25)
- could require the appointed actuary of a company which carries on long term business “to make an investigation into its financial condition in respect of that business, as at a specified date” (s.42(1)(a))

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<sup>65</sup> These terms have been used variously in Annual Bonus Statements, Annual Reports, and letters to policyholders.

- could “require a company to furnish to the Treasury, at specified times or intervals, with information about specified matters” (s.44)
- allowed the Treasury by order (on the application of or with the consent of a company), to exclude a company from any of the provisions of Part II of the Act or modify its provision (s.68). In practice this power has been used to modify the way that the asset and liability valuation rules apply to particular companies to reflect their particular circumstances

Part III of the Act relates to conduct of business.

A.3 A purpose of the Act was clearly to ensure the financial strength and probity of companies undertaking long term business, and it provided the Treasury with a comprehensive set of powers to fulfil the purpose of the Act. The Act does not lay any explicit duties on the Secretary of State (and subsequently the Treasury) to exercise the powers<sup>66</sup>. The Act gave the Treasury powers to ensure that it can obtain the information it needs to regulate, and some of the information is put in the public domain.

A.4 The **Financial Services Act 1986** provided wide-ranging legislation to regulate the carrying on of investment business. The Act created “self-regulating organisations” (which is an oxymoron, and a delusion that should have ceased with the Lloyd’s scandal), which were authorised by the Secretary of State. As soon as the Act was brought into force his powers were delegated to the Securities and Investment Board (**SIB**), which oversaw the self-regulating organisations. Since 1994 the organisation responsible for regulating retail business was the PIA, and companies offering life assurance were obliged to be a member of the PIA. The PIA defined rules of conduct, and its formal powers of intervention included prohibiting a member from entering into specified types of transactions, or soliciting business from persons of a specified kind or carrying on business in a specified manner. It could issue reprimand orders, impose fines, and expel a member. The PIA Ombudsman was a subsidiary of the PIA, and had jurisdiction to resolve complaints against the members.

A.5 Among other things the Act allowed the Secretary of State - and hence the SIB - to make rules regulating the conduct of investment business; allowed the SIB to call for “such information as it may reasonably require for the exercise” of its functions under the Act; and provided it with powers to protect investors by intervening in the affairs of a company undertaking investment

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<sup>66</sup> Consequently it probably does not create a legal right to or legal remedy, and in particular damages against the Secretary of State or Treasury in the case of failure to exercise the powers on the grounds that the need to exercise the power to protect policyholders should have been evident to the person with the power, unless perhaps the conditions for establishing that the tort of misfeasance in public office are satisfied (c.f. paragraph 2.8 above). Any remedy must be through the political process.

business. The Act also set up the Financial Services Tribunal whose purpose was to provide an appeals body against decisions taken by the Securities and Investment Board.

A.6 Details of implementing aspects of the Insurance Companies Act 1982 are set out in the **Insurance Company Regulations 1994** (the 1994 Regulations), which among other things prescribed the bases for the valuation of liabilities, defined the concept of the solvency margin for life companies and required companies to have a margin that exceeded a “required minimum margin” (RMM) which is about 4%. In addition to assets that appear in the balance sheet, various financial devices were allowed as assets for calculating the reserve margin (see below).

A.7 Life companies could, either by EU directives commencing with the 1979 First Life Directive (79/267/ECC) and/or under the 1994 Regulations (subject where appropriate to agreement with the Secretary of State/Treasury under a “Section 68 Order”), “improve” their solvency margin through the use of five main financial devices some of which are mere financial engineering of negligible substance. The first three are called “implicit items” in the 1994 Regulations, and can amount to up to five sixths of the required minimum margin:-

- unlike for “normal” UK commercial companies, where prudent accounting requires that profits are not booked until they are realised, life companies are allowed to bring forward the capitalised value of future estimated profits, which is referred to as a “future profits implicit item”. The practice is allowed under the 1979 EU Directive subject to the approval of the Member State regulatory authority. The future profits item specified in the Directive equals in effect the sum of 50% of the average profits earned over the last five years for each policy extended by the expected duration of the policy. The practice is being phased out following an EU solvency directive
- a company can spread the acquisition costs of regular premium policies over the lifetime of policies in proportion to the premiums receivable, which has the effect of reducing the calculated reserves for liabilities by reducing the costs in a year. The practice is known as a Zillmer adjustment or “Zillmerising”<sup>67</sup> and is allowed under the 1979 EU Directive *subject to the approval of the member state regulatory authority*
- hidden reserves can be used to improve the solvency margin, but The Equitable had none
- the 1979 EU Directive allows a loan that is subordinate to the rights of policyholders to be counted as an asset but not counted as a liability for purposes of calculating the solvency margin *provided that the loan does not exceed half of the required minimum margin*. The Member State regulatory authority does not have discretion over a company raising a loan. The value of the reinsurance contract for solvency purposes is determined by the Appointed Actuary of a firm in

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<sup>67</sup> To quote the 1994 Regulations “zillmerising means the method for modifying the net premium reserve method of valuing a long term policy by increasing the part of the future premiums for which credit is taken so as to allow for initial expense”. Dr. Zillmer was a Prussian who wrote a paper in 1863.

accordance with the solvency rules, *but a Member State regulatory authority may review the basis on which the value is calculated*

- the 1979 EU Directive allows reinsurance contracts to be counted as an asset for purposes of calculating the solvency margin. In theory a reinsurance contract shifts risk from the party insured to the reinsurer, and such contracts count as an asset. The Member State regulatory authority does not have discretion over a company entering a reinsurance contract. The value of the reinsurance contract for solvency purposes is determined by the Appointed Actuary of a firm in accordance with the solvency rules, *but a Member State regulatory authority may review the basis on which the value is calculated*

A.8 The **Financial Services and Markets Act 2000** is a wide ranging Act to regulate many financial services and also exchange based markets. It repealed the Insurance Companies Act 1982 and the Financial Services Act 1986 and allowed for the continuation of many of the provisions of those Acts as powers for the Financial Services Authority<sup>68</sup> (FSA), into which the SIB had been transformed in 1997. The 1994 Regulations were superseded on 1/12/2001 by the FSA's Interim Prudential Source Book.

A.9 The FSA has as regulatory objectives (s.2):-

- “(a) market confidence
- (b) public awareness
- (c) the protection of consumers
- (d) the reduction of financial crime”

A.10 The public awareness objective “includes, in particular, promoting the awareness of the benefits and risks associated with different kinds of investment or other financial dealing” (s.4(2)(a)), while the protection of consumers objective includes having regard to “The needs that consumers<sup>69</sup> may have for advice and for accurate information” (s.5(2)(c)). The Authority has power to require participants in the financial services business to provide information and documents (s.165(1)), and has the powers to investigate matters. The Act sets up an Ombudsman Scheme (The Financial Ombudsman Service), whose purpose is to handle individual complaints against companies providing consumers with financial services, and the Financial Services and Markets Tribunal. This Tribunal supersedes the Financial Services Tribunal, and provides an appeals body against regulatory decisions taken by the FSA.

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<sup>68</sup> Note that by s.19(1) of Schedule 1 “Neither the Authority nor any person who is, or is acting as, a member, officer, or member of staff of the Authority is to be liable in damages for anything done or omitted in the discharge, or purported discharge, of the Authority's functions”.

<sup>69</sup> Note that the term “consumer” embraces both the individual retail purchasers of financial products and purchases by professionals such as stockbrokers.