



# **“Unsafe and unsound”**

## **a critique of the Chadwick Report**

A paper by Alex Henney, Director of EMAG, 3 September 2010

## EXECUTIVE SUMMARY AND INTRODUCTION

In her massive report “Equitable Life: a decade of regulatory failure” (July 2008) the Parliamentary Ombudsman (Parliamentary Ombudsman) Anne Abraham, found ten cases of maladministration by government regulators and the Treasury’s agent the Financial Services Authority (FSA), and she found extensive injustice which resulted either in direct financial loss or “loss of opportunity”. She recommended that the government should establish a scheme “to put those people who had suffered a *relative loss* back into the position that they would have been in had maladministration not occurred” (italics added). **She implicitly endorsed EMAG’s estimate of £4.8bn of relative loss**, which the Treasury’s own actuaries<sup>1</sup> Towers Watson have broadly confirmed.

The discredited Labour government responded in January 2009<sup>2</sup>, rejecting most of the cases of injustice which cut out about 90% of the relative loss, and appointed a retired judge, John Chadwick, to advise it on an *ex-gratia* payment scheme. EMAG took the government to a judicial review, which in October 2009 resulted in the government having to reinstate some - but not all – of the key findings of injustice. The government enjoined Chadwick to “disregard findings which are not accepted”, an instruction that had very significant implications for Chadwick in his report of 310-page report backed with four hundred more of actuarial material published on 22 July 2010<sup>3</sup>. Chadwick – acting as an advocate for the government, not as an independent judge - knew what the piper wanted and decimated the assessment of loss. He started by slicing the beginning and the end:-

- The Parliamentary Ombudsman determined that losses started from the second half of 1991. Chadwick contrived specious reasons for moving the date to 31 December 1992, **which cut the estimated relative loss by about £750m.**
- Although the government accepted the finding of maladministration with injustice regarding the phony reinsurance treaty, in an extraordinary and virtually incomprehensible piece of “reasoning”, Chadwick “retried” the issue effectively eliminating the consequences of a disgraceful regulatory failure.

He devised a spurious redefinition of the Parliamentary Ombudsman’s “relative loss” which he called “External Relative Loss”, and pretended this equalled her concept. **This manipulation reduced the loss to £2.3–£3.0bn.** He asked Towers Watson to reconstruct to his formula how Equitable might have performed had it been regulated without maladministration. This subjective and biased exercise assumed that the regulators would have been almost (but not quite) as pusillanimous as the maladministrative ones had been. The aim was to show that absent maladministration Reconstructed Equitable would have performed little differently because from what actually happened, because from the twisted logic he applied to assessing the supposed loss of policyholders, the smaller the difference the less would be his assessment of losses. And so the less the compensation from government.

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<sup>1</sup> Towers Watson in a letter to Mark Hoban, 21 July 2010.

<sup>2</sup> The Government’s response to the Report of the Parliamentary Ombudsman’s Investigation, Cm7538, January 2009.

<sup>3</sup> Advice to government in relation to the proposed Equitable Life payment scheme, J. Chadwick, July 2010. Advice to government in relation to the proposed Equitable Life payment scheme, J. Chadwick, July 2010.

From the Reconstruction he also devised another meaningless metric “Internal Relative Loss” which he pretended the Parliamentary Ombudsman would have developed but for “the fact that she was not able to make findings regarding the actions of persons other than the public bodies which she had investigated. This absurd surmise was typical of his too often outlandish “logic”.

Chadwick’s coup de grâce was then to guesstimate (i.e. to minimise) the proportion of policyholders who might have left the hypothetical Reconstructed Equitable, which was easy since it produced not dissimilar performance. So he was able to conclude “that there would have been some, but not a large, reduction in the extent of the new investment income”, which he estimated as 25% to 20% depending on the type of policy. He applied these factors *illogically* to External Relative Loss and 75% and 80% to Internal Relative Loss and added them together to arrive at **£4–£500m**

**With two fabricated cumulative deductions of 45% and a further 80%, he gets from an estimate of relative loss of about £4.8bn, per the Parliamentary Ombudsman, down to his proposed compensation figure of £400–£500m.** Chadwick explains the substantial divergence between his views and those of the Ombudsman thus: “*We have reached different answers because we have addressed different questions.*” But the question she was answering was what and how maladministration led to injustice, while he was answering how to come up with seemingly plausible reasons for cutting the government’s liabilities for its incompetence and misbehaviour.

The Parliamentary Ombudsman immediately wrote a letter to MPs on 26 July, 2010 in which she stated unequivocally that Chadwick’s report “would not in any sense enable fair and transparent compensation to be delivered”, and was “unsafe and unsound”. She also commented that “It misrepresents central parts of the conclusions outlined in my July 2008 report and has ignored others”.

This report aims to expose the dissembling and dishonesty of the Treasury. Mark Hoban has described the Chadwick report in Parliament as “challenging and complex”. It is so because its aim is not to develop the Parliamentary Ombudsman’s relatively straightforward concept of relative loss, but to devise a seemingly complex methodology to cut the assessment of loss. Furthermore, whether by intent to obscure or due to Chadwick’s limited expressive skills, it is badly written, with convoluted hair splitting mumbo jumbo, dense legal language and actuarial alchemy. Just as “a picture is worth a thousand words”, so in this type of analysis, expressing concepts algebraically and numerically, not only makes it easier for the reader, but also acts as a discipline on the writer. Perhaps the lack of clear numerical explanation is because Chadwick is not particularly numerate, nor familiar with money issues – or is it a clever intent to confuse? The main text of Chadwick’s document could have been written more clearly in at most half – if not a third – the length - *but then that would have clearly exposed its logical flaws.*

These are serious criticisms, which are not credible as mere generalisations. They must be substantiated in detail, which is the objective of this report. To that end, the critique is developed in moderate length in the main text and then supported in further detail by Annexes including one presenting the gibble-gabble of

Chadwick's ratiocination, which has to be read to be believed (Annex 5). Although they are not a light read, the reader can be assured they are much less tedious than Chadwick's turgid tome – any doubting Thomas can go to [http://chadwick-office.org/downloads/Sir\\_John\\_Chadwick\\_Advice.pdf](http://chadwick-office.org/downloads/Sir_John_Chadwick_Advice.pdf) to remind themselves!

The publication of Chadwick's document together with its backing material does no credit to the Treasury, some of whose officials cannot be but aware of its shortcomings. They know full well that most MPs and journalists will not read it but will instead be impressed by its weight and the number of pages (2,200), and of those who do try to read it very few will be able to understand it. We imagine it has been published as a smokescreen, in order to claim that a detailed, complex and, by insinuation objective, study has been undertaken which shows that claims by EMAG that Equitable policyholders lost in the order of £5bn are bunkum, and the real figure is a fraction of this sum. But it is Chadwick and those officials on cost indexed pensions who are peddling bunkum.

**The main report comprises five sections:-**

1. The Parliamentary Ombudsman's recommendation of Relative Loss as a basis for compensation
2. The Government's Response – the first slice
3. Chadwick begins slicing
4. The "Reconstructed" Equitable
5. Decimating "Relative Loss" in easy stages

**There are seven annexes:-**

1. The Parliamentary Ombudsman's Findings of Maladministration; their consequences and her findings of injustice
2. The Government's Response to the Findings
3. Chadwick's Disposal of Finding 6
4. The Fabrication of a "Reconstructed" Equitable
5. The semantic travails and travels of "Absolute Loss" and "Relative Loss"
6. Redefining "Relative Loss" and contriving "Internal Relative Loss"
7. The Coup de Grâce

## 1. THE PARLIAMENTARY OMBUDSMAN'S RECOMMENDATION OF RELATIVE LOSS AS A BASIS FOR COMPENSATION

In her massive report "Equitable Life: a decade of regulatory failure" <sup>4</sup> (July 2008) the PO Ann Abraham, found 10 cases of maladministration by government regulators and the Treasury's agent the Financial Services Authority (FSA), and she found extensive injustice which resulted either in financial loss or "loss of opportunity". Annex 1 sets out the PO's ten findings of maladministration and her findings of injustice that EMAG's judicial review forced the government to accept injustice regarding findings 2 and 5, which took the injustice back from 1 May 1999 to July 1991. Unfortunately she did not find injustice for findings 7 and 9 because she assumed that people affected would be covered by finding 6; subsequently the Treasury and Chadwick took advantage of this omission.

Her main report is a story of initially gross incompetence, feebleness, and bureaucratic pusillanimity by the regulators followed by attempts at cover up. She rightly refers to "the justifiable sense of outrage" of those who complained to her. She recommended that the government should establish a scheme "to put those people who had suffered a *relative loss* back into the position that they would have been in had maladministration not occurred" (italics added). She implicitly endorsed EMAG's estimate of £4.8bn of relative loss, which the Treasury's own actuaries<sup>5</sup> have recently confirmed.

**Her "second-and-central recommendation is that the government should establish and fund a compensation scheme... [whose aim] should be to put those people who have suffered a relative loss back into the position that they would have been in had maladministration not occurred."** (138).

Her concept of "relative loss" was set out in Chapter 14 of her main report. She refers (3) to her reports "Principles for Remedy" and "Principles of Good Administration" which sets out her "underlying principle to seek to ensure that the relevant public body restores the complainant to the position he or she would have been in, had the maladministration not occurred" (5). She defines "financial loss in relative terms – that is, they have suffered a loss that they would not otherwise have suffered had they invested or saved elsewhere than in the Society" (27). She states (33) "That brings me to **relative loss**", and cites (34) "... the approach that the Financial Ombudsman Service takes to the question of remedying financial loss is a comparative approach". She quotes the case of Mrs E where the Financial Ombudsman concludes "Therefore, compensation is to be assessed by comparing the return Mrs E received on the money she put into a with-profits pension with Equitable Life and the return she would have received from a similar product with an alternative provider."<sup>6</sup>

EMAG estimated this sum at **£4.7bn in 2008** (interest will have increased it with the passage of time) and the Treasury's actuaries Towers Watson calculated it at **£4.0 - £4.8bn**. In the light of analysis, this appears to be an underestimate because 1) the period July 1991 to December 1992 was cut off; 2) Towers Watson

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<sup>4</sup> Equitable: a Decade of Regulatory Failure – Part One: Main Report, July 2010.

<sup>5</sup> Towers Watson in a letter to Mark Hoban, 21 July 2010.

<sup>6</sup> For the avoidance of doubt she mentions the accumulation of interest (26).

subtracted market value adjusters from Elsewhere Life, which was not appropriate<sup>7</sup>; and 3) we think that there are other technical reasons for further underestimating the returns from investing in the comparators.

## 2. THE GOVERNMENT'S RESPONSE - THE FIRST SLICE

After an unnecessarily long delay to further spin out the process, the discredited Labour government responded in January 2009<sup>8</sup> six months after the PO reported. It rejected most of the cases of injustice, but significantly accepted that in respect of the possibly fraudulent and definitely valueless reinsurance treaty relating to the 1998 regulatory returns that were published in 1999. The rejection of early injustices cut out about 90% of the relative loss leaving only those losses after 1999.

The government also appointed a retired judge, John Chadwick, who has legal work in Dubai, the Cayman Islands, Guernsey, and occasional locums in the Appeal Court, to advise it on an *ex-gratia* payment scheme for policyholders who had suffered "*disproportionate loss*". The then Chief Secretary to the Treasury, Yvette Cooper, claimed that Chadwick's advice would be "independent". This is nonsense – the Treasury set the terms of reference; provided the Secretary to the exercise, Simon Bor; appointed the firm of actuaries, Towers Watson; and paid Chadwick, who clearly knew who the piper was and what tune was wanted. EMAG took the government to a judicial review, which in October 2009 essentially forced the government to accept injustice regarding findings 2, 4 and 5, which took the injustice back from 1 May 1999 to July 1991. The Treasury paid £300,000 of EMAG's costs. In a JR it is not advisable to be too complex, so we did not go pursue every avenue. This left the Treasury slither room.

Annex 2 sets out the findings of maladministration resulting in injustice which the government accepted and set out in Chadwick's Terms of Reference. He was instructed to "disregard findings which are not accepted by the Government." In relation to the Findings accepted, Chadwick was asked to advise the Treasury on:-

- "The extent of relative losses suffered by different classes of policyholder in respect of each case of maladministration, taking account of, among other things, wider market conditions during the period under consideration, and comparable insurance products available over the same period
- The proportion of those losses which it would be appropriate to apportion to the public bodies investigated by the Ombudsman, as opposed to the actions of Equitable Life and other parties
- The classes of policyholders which have suffered the greatest impact as a result of maladministration
- Factors, arising from this work, which the Government might wish to take into account when reaching a final view on determining whether disproportionate impact has been suffered
- The nature and extent of the finding of maladministration and injustice in relation to Finding 5 and the nature and extent of the finding of injustice in relation to Findings 2 & 4 so far as those Findings are now accepted"

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<sup>7</sup> Policyholders who left Equitable with an uncontracted exit in order to leave a stricken fund had to pay a market value adjuster. If they had invested in Elsewhere Life they would have had no reason to leave and so incurred no exit fee.

<sup>8</sup> The Government's response to the Report of the Parliamentary Ombudsman's Investigation, Cm7538, January 2008.

The Treasury also asked Chadwick to consider “the extent to which the regulatory returns in each of the years for 1990 to 1996 would have been different if the maladministration accepted by the government had not occurred”.<sup>9</sup> He was not asked “how would Equitable have performed if it had been *effectively* regulated”.

### 3. CHADWICK BEGINS SLICING

Chadwick’s report was published on 22 July 2010<sup>10</sup>. He began by slicing off the earliest and latest periods of maladministration with injustice:

- The Parliamentary Ombudsman wrote “*Anyone investing in the Society - whether as a new investor or as someone making a further investment in it – from the second half of 1991 onwards was at risk of being misled*”. Chadwick made two excuses for moving his starting date for assessing loss from 1 July 1991 to 31 December 1992. The first was a story that the regulators would not have required Equitable to republish its regulatory returns for 1990, but would have required Equitable to have adjusted the return for 1991. This would have been published in July 1992 but would have had no impact until September 1992. Then there were claims of shortcomings with the data available in electronic form from Equitable, which took the date to December 1992. The current Chief Executive of Equitable suggested that “alternative methods of estimating data should be adopted”<sup>11</sup>, but this was ignored. **We estimate that lopping off 18 months cut the estimated relative loss by about £750m.**
- Although the government accepted the finding of maladministration with injustice regarding the phony reinsurance treaty (and told the Court so), in an extraordinary and virtually incomprehensible piece of “reasoning”, Chadwick claims that since the Court took the view that he was “not bound by the government’s observations” on the finding, he could review the finding itself, see Annex 3. He “retries” the issue based on the Reconstructed version of Equitable’s returns which assumes “that the liabilities of Equitable Life would have been larger by an amount equal to the amount of credit that was in fact taken for the Treaty” – so it would not have been required at all for a treaty. According to his specious sophistry few policyholders lost out from the blatant and accepted misrepresentation of Equitable’s financial position.

Chadwick thus managed to reduce the Parliamentary Ombudsman’s “decade of regulatory failure” to seven and a half years.

### 4. THE “RECONSTRUCTED” EQUITABLE (see Annex 4 for a more detailed account).

#### The biased assumptions

For the fabrication of a counterfactual Equitable “if the maladministration accepted by the government had not occurred” Chadwick made the following broad and unprovable assumptions:-

- (i) that the management of Equitable Life would not have altered as a result of regulatory action;

*Comment: Roy Ranson would have remained both as Chief Executive and Appointed Actuary, which the PO had found maladministrative but the government rejected. So under the Reconstruction the regulators are assumed to have allowed inadequate actuarial checks and balances and nullified the Appointed Actuary’s role as whistleblower..*

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<sup>9</sup> Conflated request under findings 2, 4 and 5 taken from Annex A of Chadwick’s Advice.

<sup>10</sup> Advice to government in relation to the proposed Equitable Life payment scheme, J. Chadwick, July 2010. Advice to government in relation to the proposed Equitable Life payment scheme, J. Chadwick, July 2010.

<sup>11</sup> Letter from Chris Wiscarson to J. Chadwick, 9 April 2010, in Supplementary Material (sections VII to XII) of Chadwick’s Advice.

- (ii) that the management of Equitable Life would have sought to pursue the same business strategies as were actually pursued; and so would have resisted attempts by the regulators to procure that relevant decisions were taken which differed materially from the decisions actually taken; and

*Comment: in effect this meant that Reconstructed Equitable would pursue policies of a “full distribution” together with informing policyholders about their total (i.e. guaranteed and non-guaranteed) bonuses, and not withholding surplus to build up an estate. Also it would attempt to grow its way out of the problem of overbonusing by running a Ponzi scheme and hoping that growth of premiums and assets and growth of stock prices would pull the chestnuts out of the fire. To this end Towers Watson assumed “the setting of the bonus rate was frequently influenced by marketing considerations and we assume this would also have been the case for Reconstructed Equitable Life.” This would be instead of setting bonuses in relation to existing assets.*

- (iii) that the prudential regulators would have taken such steps (and only such steps) in relation to the matters which are the subject of accepted Findings of maladministration as were necessary to meet the legal and administrative obligations which the Ombudsman identified in her Report.

*Comment: Chadwick clearly intended a scenario with the minimum regulatory effort; that the regulators would not take decisive actions; and would probably back off if Equitable resisted.*

He began at the beginning as he intended to go on, claiming that the regulator would not have required republication of the 1990 regulatory returns which overstated Equitable’s financial strength (although the regulators had required other companies to republish). Furthermore, notwithstanding the supposed regulatory principle of “freedom with publicity”, the regulators would not publicise their concerns about Equitable’s overbonusing.

Towers Watson assumed that the regulator and Equitable would have agreed to bring the aggregate of policy values “into line with its total with-profit assets...”, but the Reconstruction only achieved that objective **over a decade**. Furthermore this policy would not have provided a smoothing fund, which policyholders were led to believe existed, and for lack of which Ranson was expelled by the Institute of Actuaries.

Most significantly Chadwick and Towers Watson tried to play down the significance of the regulator’s duty to protect “Policyholders’ Reasonable Expectations” (PRE), which was enshrined in the Insurance Companies Act 1982, in relationship to overbonusing. Towers Watson mentioned that “in principle, the regulator had the power formally to enforce companies to take account of PRE and could therefore have intervened in Reconstructed Equitable Life’s affairs by direction”. But naturally this possibility was waved away because “the management of Reconstructed Equitable Life would have resisted any requirement to change its bonus philosophy or practice, including by threatening judicial review of any formal direction or order against it”. The regulator, being a pussycat, would of course back down.

Chadwick could dispense with Finding 3 (for which the government did not accept maladministration) that the Government Actuaries Department (GAD) failed in various ways when Equitable introduced its differential bonus policy in 1993. One consequence was that Reconstructed Equitable was not required to begin reserving for GAR’s until 1995, and then the level of reserving was too low.

Regarding the sixth Finding, the scandal of the phony reinsurance treaty, as noted above that was airbrushed out. *Chadwick pretended that he was not bound by this finding<sup>12</sup> that “ in respect of all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999, any financial loss that they have sustained constitutes injustice in consequence of maladministration. Those affected by that maladministration have also suffered injustice in the form of lost opportunities to take informed decisions about their financial affairs”.*

### The flawed results

All of the assumptions made were clearly consistent with the Treasury’s wish to fabricate a Reconstruction that was as similar to Equitable’s actual experience as possible since the difference would impact significantly on the assessment of loss which Chadwick contrived – the smaller the difference, the smaller the “loss”. The figures for the bonus rates and the ratio of aggregated policy values to asset values (PV/A) for the Reconstruction compared with the actual figures show that they achieved this objective.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bonus rates												
The bonus rates for no reduction	12.0	8.5	8.5	13.0	8.0	9.5	10.0	13.0	10.0	12.0	3.3	-11
Actual bonus rates	121.0	12.0	10.0	13.0	10.0	10.0	10.0	13.0	11.0	12.0	3.3	-16
PV/A ratio												
Reconstructed PV/A ratio assuming 20% reduction in premium income <sup>13</sup>	128%	121%	112%	98%	114%	107%	107%	104%	102%	101%	109%	
Actual PV/A ratio	128%	125%	116%	102%	120%	112%	111%	107%	105%	103%	112%	

Sources: Tables 4.2, 4.3, 4.4 of Towers Watson’s report.

Chadwick drew the following conclusions:-

- (i) the Society would have declared lower bonuses in some years during the period 1990 to 2000;
- (ii) the Society would have looked financially weaker prior to 2000 (but not significantly so) than it did, in fact, present itself;
- (iii) there would have been some reduction in premium income, both in respect of new policies and in respect of existing policies;
- (iv) ... the Society would have closed to new business at the end of 2000 (at or about the time that it did, in fact, do so following the decision of the House of Lords in the Hyman litigation and its unsuccessful attempt to sell its undertaking).”

The Reconstruction is based on making assumption after assumption in favour of minimal regulatory action. Equitable would have continued for the whole of the 1990s to have overbonused except perhaps marginally for 1993; the regulators would have hidden many of their concerns from the public; Reconstructed Equitable would not have had a smoothing fund; it would not have dealt with the GAR problem adequately; and it would have collapsed when it did. *Such a performance is hardly an advertisement for Chadwick’s view of how Equitable should have been regulated.*

<sup>12</sup> Para 1.40 Chadwick’s Advice to Government in relation to the proposed Equitable Life payment scheme.

<sup>13</sup> This scenario was chosen because Chadwick assumes a 20% loss of premium income when he is cutting the loss. There is, however, little difference to the other scenarios.

As the current Chief Executive of Equitable observed to Chadwick:-

“the counterfactual process that you have pursued in analysing what might have happened year by year is complex, deeply subjective and, most importantly of all, does not address the fundamental point that regulators failed to accumulate their knowledge in a way which could have made the eventual Equitable crisis predictable and therefore to a much greater extent avoidable.

The thrust of section 2 is that regulators responded to only the things that were within their remit and only in a short term fashion. There is a point which could have begun as early as 1990 when effective regulators ought, within their stated powers, to have been required to contemplate “what’s the worst that can happen”.

#### What could (and should) have been different with effective regulation

The regulators could have acted forcefully in the early 1990s to address the overbonusing and subsequently kept policy values below assets. They could have required Equitable to tackle the GAR problem in 1994, when there were a number of options open including separating the GAR and non-GAR policies into two separate funds. This would, quite properly, have placed the growing burden of the guarantee upon those whose policies contained that benefit. Non-GAR policyholders would have been protected and their premiums could have been invested in a normal mix of fixed interest securities, property and equities. The Hyman case would never have happened; policyholders would not have lost £ billions; and perhaps Equitable would still exist as a viable with-profits fund.

A common factor in both these solutions to Equitable’s fundamental problems is that they would have involved public acknowledgement that they existed. Policyholders and commentators would have noticed a big bonus cut for 1990 and the segregation of the fund in 1994, and many would have invested elsewhere or not invested with Equitable in the first place. It is quite likely that the company would have survived the GAR problem, and Equitable might still be operating a real with-profits fund today.

#### 5. DECIMATING RELATIVE LOSS IN EASY STAGES

Having chopped off the first 18 months of the period and effectively massively reduced the loss of those who invested after the phony reinsurance treaty, Chadwick set to work reduce the “loss” due to maladministration and injustice accepted by the government for the middle period. He reinterpreted the Parliamentary Ombudsman’s definition of “relative loss” and called it “External Relative Loss”, and second created a completely specious new concept which he calls “Internal Relative Loss”. He then combined them into a weighted composite, but not until he had applied a discount figure based on the proportion of revenue he concocted that Equitable might have lost from people shifting their premiums elsewhere.

### “Absolute Loss”

After some logical somersaults Chadwick claims (4.10) “it is, I think, plain that (at that stage in her analysis) the Ombudsman had in mind that, in order to determine whether a policyholder has suffered “relative loss”, it would be necessary to ask each of the first two questions which she had posed earlier:

- (i) whether the policyholder had suffered a financial loss in absolute terms in respect of his investment with the Society; and
- (ii) if so, whether that financial loss would have been suffered if the policyholder had invested elsewhere.

The effect of this approach is that the answer to the first question provides a ‘cap’ to the calculation of “relative loss”. “Relative loss” cannot exceed the amount of “absolute loss”: it must be less than or equal to that amount.” Unfortunately Chadwick’s expressive skills do not extend on pages 109-112 to providing a comprehensible description of “absolute loss”. The clearest statement is in Towers Watson’s side letter to Hoban of 21 July:-

“Absolute loss is derived as the difference between the payout (allowing for the guarantees in the policy terms) that would have been received (or would have been received in the future) by the policyholder in respect of the relevant Equitable Life policy, if the final policy value cuts of 2001 and with-profit annuity cuts in 2003 had not occurred and the payout which has actually been received (or will be received in the future), in respect of the Equitable Life policy. The estimate is the aggregate across all policies”.

It is however noteworthy that the concept is not relevant for considering “relative loss” because (1) as the Parliamentary Ombudsman pointed out not all of the cut was due to maladministration, and (2) poor bonus levels after 1994 were due to earlier maladministration. Chadwick introduces the concept in order to incorporate it into his “External Relative Loss” cutting formula.

Annex 5 sets out in more detail Chadwick’s tortuous routes to defining “Absolute Loss” and “External Relative Loss”.

### Chadwick’s perverse redefinition of “relative loss” (Annex 6 elaborates on the redefinition)

In ten tightly packed pages (112 - 121) of dense, often misleading text and specious semantic gymnastics Chadwick reinterprets the Parliamentary Ombudsman’s meaning of “relative loss” by breaking it apart into bits, and examining the bits in order to see where and how he can cut it. Along the way Chadwick claims “I do not find that reasoning [vis, by the Parliamentary Ombudsman] easy to follow” (perhaps because he was contriving to twist her meaning), and proposes that “there is a shift in the sense she used “relative loss” which is in his mind’s eye. With further twisted and tortuous logic he says “I shall refer to relative loss, in the sense employed by the Ombudsman, as “External Relative Loss”, which is not a concept of recognised economic or accounting meaning. Essentially stripped of verbiage his definition often equals “absolute loss”.

The effect of the two stages he enunciates is illustrated by the example of a hypothetical policyholder who invested £10,000 in a pension policy at the beginning of 1995 and by December 2000 the total policy value was £16,531. On 16 July 2001 it was cut by 16% (£2,645) leaving £13,886 which was taken on a contractual exit without suffering any penalty. If the person had invested in Elsewhere Life his fund would have been worth £18,668. "Relative Loss" is £4,782 while "External Relative Loss" or "Absolute Loss" is £2,645, a reduction of 43%. Towers Watson's aggregate figures were £4.0 - £4.8bn for aggregate Relative Loss<sup>14</sup> and £2.3 - £3.0bn for aggregate External Relative Loss representing a roughly similar percentage difference.

Mark Hoban commented in Parliament (without mentioning the concept):-

"For a number of policyholders, because of the strong performance of comparable life companies, their relative loss is greater than the absolute loss they suffered. Consistent with the ombudsman's recommendation, Sir John has advised that relative loss for an individual policyholder should be capped at the absolute loss they suffered. It is hard to see how it would be fair either to the taxpayer or to other policyholders if some policyholders received more through redress than they had actually lost. If the proposed cap is adopted, then the figure will be £2.3 billion to £3 billion."

***It is noteworthy that the Parliamentary Ombudsman clearly recommended compensation for relative loss; she most definitely did not recommend capping; and the (very debatable) statement about 'fairness to the taxpayer' undermines her principle of relative loss to which the Coalition is pledged.***

Next Chadwick creates another fictitious concept "what I shall describe as the "Internal Relative Loss" suffered by each policyholder". After three pages of dense prose he explains that Internal Relative Loss is the difference between:-

- (a) what the policyholder would have received (or would in the future receive) in respect of his investment in Equitable Life with-profits policies if, in the regulation of the society, the maladministration which the government accepted had not occurred;
- (b) what the policyholder has received (or will receive in the future) in respect of his investment in Equitable Life with-profits policies in the events which happened. (6.3)

This is another concept of no economic or accounting significance or relevance other than as a device contrived for cutting loss.

#### Determining a "loss of opportunity" discount

Since it is not practical to attempt individual loss assessments based on who took how much notice of publications about Equitable more than a decade ago. Chadwick claims that "... the fairest practical way of assessing External Relative Loss would be to treat all who invested in the Society during the relevant period as having suffered External Relative Loss, but to discount the loss so assessed by a proportion equal to the proportion by which the premium income received by the Society during the relevant period would have been

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<sup>14</sup> Note: these figures are an underestimate by at least £¾bn because (1) of the truncated period used, and (2) Towers Watson appears to have underestimated the bonus returns of the comparator companies used to calculate relative loss.

reduced absent maladministration.”<sup>15</sup> So he sets about assessing that proportion, which he wants to make as small as possible. (7.1) *A critical point in this description is that it is “absent maladministration”.*

As we saw, the Reconstruction of Equitable’s performance absent maladministration was devised so that its performance was only marginally different to those actually achieved. So Chadwick concluded “Taking factors which I have identified and discussed into account, I am satisfied that there would have been some, but not a large, reduction in the extent of the new investment income which the Society would have received in the relevant period if the accepted maladministration had not occurred. In my view, the proportionate reduction would have been between one sixth and one quarter.” (7.76)

However, it is important to be clear that while a “loss of opportunity discount” is appropriate for situations where ex-post it is not clear who might have acted one way or another, it is not appropriate to use it for those who have suffered a definite and specific measurable loss. Yet Chadwick’s External Relative Loss capped by his Absolute Loss appears (as best can be told from his drafting) to be just such a definite loss. In that case an opportunity loss discount should not be applied.

#### The coup de grâce

In a procedure which has no logic, Chadwick decides to conclude that policyholders’ loss equals a composite weighting of External Relative Loss (ERL) and Internal Relative Loss (IRL), where the weighting is based on the supposed proportionate reduction of income (call it X) so that his loss equals:-

$$\text{ERL} * (1 - X) + \text{IRL} * X$$

He concluded that X = 79%, the proportion to be used in the case of investment in with-profits annuities policies and 80% in the case of all other policies.

Chadwick’s methodology was first to cut values by 45% then by a further 79% and lo and behold he has got from the estimate of around £4.5bn for the Parliamentary Ombudsman’s concept of relative loss down to £400–500m of his advice. Eliminate the Parliamentary Ombudsman’s concept; think of a couple of meretricious concepts based on hairsplitting sophistry; throw in a few more arbitrary factors – and bingo; he has cut the loss by 90%.

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<sup>15</sup> EMAG suggested this approach to the Parliamentary Ombudsman based on the practice of courts in dealing with ‘loss of chance’ cases following the *Chaplin v Hicks* case of 1911..

ANNEX 1: THE PARLIAMENTARY OMBUDSMAN'S FINDINGS OF MALADMINISTRATION; THEIR CONSEQUENCES AND HER FINDINGS OF INJUSTICE

	<b>Ombudsman's findings of maladministration<sup>16</sup></b>	<b>The consequences of maladministration</b>	<b>Ombudsman's findings of injustice</b>
1.	The DTI failed to insist in 1991 when approving Ransom as chief executive that he should relinquish his role as Appointed Actuary.	Weakened a regulatory check and balance – the DTI and GAD were “overly reliant” on one person’s view of ELAS’s financial position.	No finding of injustice (because to do so would require making findings about ELAS and Ranson, who were not within her jurisdiction).
2.	GAD failed to scrutinize regulatory returns for each year from 1990 to 1993 re:- (i) the valuation rate of interest for discounting liabilities (ii) the affordability and sustainability of bonus declarations.	GAD and DTI could not be sure that ELAS was acting prudently. ELAS gave the impression that it was financially sound and able to pay generous bonuses.	Injustice due to financial loss and/or lost opportunities, 1990 to 1996 (see #4 for balance of period).
3.	GAD failed when ELAS introduced its differential bonus policy in 1993 (i) to inform DTI (ii) to raise the issue with ELAS (iii) to understand the rationale for the policy and how it was communicated to policyholders.	The prudential regulators were disabled from discharging their duties. Did not alert potential policyholders (and existing ones making further contributions) of the liability they might assume. ELAS did not consider ring fencing new entrants. Also loss of various critical opportunities to test ELAS and obscuring the problems which eventually brought ELAS down.	Injustice due to loss of opportunities in period July 1991 to April 1999 to take decisions re exposure to GARs.
4.	GAD failed to scrutinize regulatory returns for each year from 1994 to 1996 re:- (i) the strength of the valuation rate of interest for discounting liabilities (ii) the affordability and sustainability of bonus declarations (iii) changes to assumed retirement ages (iv) holding of no explicit reserves for capital gains tax, pension mis-selling costs, and GARs.	Repeats finding #2 as regards items (i) and (ii) for 1994-1996. An early opportunity was lost to address the need to reserve for the GARs. ELAS’s liabilities were understated. This maladministration reinforced finding #3.	Injustice due to financial loss and/or lost opportunities in period July 1991 to April 1999 to take decisions re exposure to GARs.
5.	GAD failed in relation to regulatory returns for 1995:- (i) to check that ELAS’s valuation was greater than the minimum required by Regulations	(i) Allowed those reading the returns to believe the financial strength of ELAS was greater than it was (ii) Those who relied on the returns were “actively misled” (iii) GAD was unable to verify the	Combined with #s 2 and 4 injustice of either financial loss or loss of opportunities 1990 to 1996.

<sup>16</sup> The findings of maladministration, consequences, and findings of injustice are taken from Part five of the Ombudsman’s report. The government’s response is taken from Cm 7538 and Chadwick’s Advice. The wording has been changed to condense it, but hopefully not alter the sense.

	(ii) to do anything when aware that Standard & Poor's was misconstruing the returns and overstating the financial strength of ELAS.	financial position of ELAS (iv) No action was taken when it was clear that parties were misconstruing information.	
6.	The FSA failed to ensure that a reinsurance treaty credited as nearly £1bn in the returns for 1998  (i) was not taken into account in the 1998 returns without an appropriate concession being given.  (ii) did not reflect the "economic substance of the treaty" – it was valueless.	(i) ELAS was allowed to declare a bonus in March 1999. If it had not it would have been a warning to the market about its "financial difficulty"  (ii) ELAS's solvency position was misrepresented  (iii) The financial weakness of ELAS was hidden from the public. Those investing were given a wholly misleading picture of ELAS's financial situation.	Financial loss by anyone investing after 1 May 1999.
7.	The FSA failed to ensure proper disclosure in the returns for 1998 and 1999 of the potential consequences of losing the Hyman litigation	(i) The DTI and GAD could not be certain that prospective investors had accurate information about ELAS – they were denied information about their potential exposure to risk  (ii) ELAS and DTI lost the opportunity to consider possible outcomes of the case  (iii) DTI could not ensure investors had full information.	She did not find injustice because anyone affected would already be covered by #6.
8.	The FSA failed to record its decision to permit ELAS to remain open.	Poor standard of administration.	Did not lead to injustice.
9.	That decision to allow the Society to stay open was unsound following the loss of the Hyman case.	(i) Policyholders did not benefit from the powers that the prudential regulator had to protect their interests by indicating the seriousness of ELAS's financial position  (ii) Those who invested did so in an environment where accurate information was not made available  (iii) "late" joiners and investors made decisions without an informed basis.	She did not find injustice because anyone affected would already be covered by #6.
10.	The FSA provided optimistically misleading information about ELAS's solvency position after it closed for new business.	Those who made decisions based them on inaccurate/ misleading information.	Financial loss and/or lost opportunities.

She further commented that "All of the specific consequences of the determination of maladministration that I have made also had three general consequences:-

- that the Society's published returns were unreliable;
- that there was lost opportunities to address critical issues earlier; and
- that regulated decisions were taken on a basis which had insufficient regard to the range of powers that the prudential regulator possessed.

ANNEX 2: THE GOVERNMENT'S RESPONSE TO THE FINDINGS

	<b>Ombudsman's findings of maladministration</b>	<b>Government's response</b>	<b>Revised terms of reference for Chadwick setting out the government's acceptance of injustice<sup>17</sup></b>	<b>Comment</b>
1.	The DTI failed to insist in 1991 when approving Ransom as chief executive that he should relinquish his role as Appointed Actuary.	Not accepted the maladministration.		This allowed Chadwick to claim no change in management or business strategy.
2.	GAD failed to scrutinize regulatory returns for each year from 1990 to 1993 re:- (i) the valuation rate of interest for discounting liabilities (ii) the affordability and sustainability of bonus declarations.	Accepted maladministration but not injustice. <b>Forced by Court to accept injustice.</b>	Accepts maladministration re (i) and (ii). In relation to injustice accepts that returns for 1990 to 1993 might have looked different if no maladministration. Seeks Chadwicks' advice on how different the returns might have looked "if the maladministration accepted by the government had not occurred".	
3.	GAD failed when ELAS introduced its differential bonus policy in 1993 (i) to inform DTI (ii) to raise the issue with ELAS (iii) to understand the rationale for the policy and how it was communicated to policyholders.	Accepted part of maladministration but none of injustice. The Court did not require acceptance.		This allowed Chadwick to delay reserving for GARs.
4.	GAD failed to scrutinize regulatory returns for each year from 1994 to 1996 re:- (i) the strength of the valuation rate of interest for discounting liabilities (ii) the affordability and sustainability of bonus declarations (iii) changes to assumed retirement ages (iv) holding of no explicit reserves for capital gains tax, pension mis-selling costs, and GARs.	Accepted maladministration but not injustice re (i) and (ii). Accepted maladministration but not injustice re (iii). Accepted maladministration and injustice re (iv) relating to the GAR reserve but not the other parts of (iv). Qualified acceptance of injustice by claiming that the GAR reserve should be "of a modest amount". Blamed inadequate returns by ELAS which did not disclose GAR situation fully in years following 1990. Did not accept maladministration re reserves for CGT and mis-	Accepts maladministration that led to injustice, in respect of (i) and (ii). Regarding (i) (ii) and (iv) the government seeks Chadwick's advice on how different the returns might have looked "if the maladministration accepted by the government had not occurred".	

<sup>17</sup> Annex A of Chadwick's advice.

		selling.		
5.	GAD failed in relation to regulatory returns for 1995:- (i) to check that ELAS's valuation was greater than the minimum required by Regulations (ii) to do anything when aware that Standard & Poor's was misconstruing the returns and overstating the financial strength of ELAS.	Government initially accepted part of maladministration but none of injustice. Forced by Court to accept injustice in respect of both parts. Asked Chadwick to advise re its "nature and extent".	Accepts maladministration and injustice in respect of (i) and (ii). Seeks Chadwick's advice on how different the returns might have looked "if the maladministration accepted by the government had not occurred".	
6.	The FSA failed to ensure that a reinsurance treaty credited as nearly £1bn in the returns for 1998 (i) was <i>not</i> taken into account in the 1998 returns without a concession. (ii) did not reflect the "economic substance of the treaty" – it was valueless.	Accepted finding of maladministration and injustices, but claimed ELAS could have explored other options. (In fact they were unrealistic).	Accepts "In relation to injustice... because the regulator permitted credit to be taken for the reinsurance treaty, Equitable Life's returns gave a materially misleading picture as to its insolvency".	
7.	The FSA failed to ensure proper disclosure in the returns for 1998 and 1999 of the potential consequences of losing the Hyman litigation.	Accepted maladministration but on a more limited basis in any event no finding of Parliamentary Ombudsman of injustice.		Parliamentary Ombudsman considered this was covered by #6, so no additional finding of injustice.
8.	The FSA failed to record its decision to permit ELAS to remain open.	Accepted maladministration.		Not relevant.
9.	That decision was unsound following the loss of the Hyman case.	Accepted maladministration with caveats. Did not accept that any injustice could have resulted from the maladministration. in any event no finding of Parliamentary Ombudsman of injustice.		Parliamentary Ombudsman considered covered by #6, so no additional finding of injustice.
10.	The FSA provided optimistically misleading information about ELAS's solvency position after it closed for new business.	Accepted maladministration and injustice with caveats. The government indulged in word play to provide slimy slither room.	Accepts the finding of injustice but believes the numbers affected are small.	

### ANNEX 3: CHADWICK'S DISPOSAL OF FINDING 6

The Parliamentary Ombudsman's Finding 6 related to the valueless reinsurance treaty which the FSA had accepted as part of its attempt to cover-up the weakness of Equitable's finances. (£809m for 1998, £1098m for 1999 and £808m for 2000). She found injustice in the following terms:-

I find that, in respect of all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999, any financial loss that they have sustained constitutes injustice in consequence of maladministration. Those affected by that maladministration have also suffered injustice in the form of lost opportunities to take informed decisions about their affairs.

In January 2009 the Government accepted both these findings, but made certain **observations** (emboldening of observations added here and below) to the effect that there were alternative courses of action "and their availability should be taken into account when assessing the impact and nature of the injustice flowing from this finding of maladministration" (para 4.140 Cm 7538).

The status of these **observations** came up in the Judicial Review, first of all in the summary judgement:-

- (i) No more need be said of the challenge to Findings 6 and 10, by reason of the clarification at the hearing of the Government's position (*Judgment/ paras. 115-117 and 121-124*).

And then in the final judgement:-

115. The Government accepted the findings both of maladministration and of injustice. However, it added certain **observations** arising out of the finding of injustice, in particular as the possible alternative courses of action steps which might have been taken by Equitable to protect its position and that of its policy-holders. These observations led to some considerable debate at the hearing before us, with EMAG submitting that they amounted to backdoor attempts at qualifying the finding of injustice. These concerns were given force by Sir John Chadwick's comments on this issues in his document, "Equitable Life ex-gratia payment scheme: My proposals as to the approach to be adopted and the issues to be addressed" ("Sir John Chadwick's proposals"), he said:-

"The effect of my Terms of Reference.... is that those paragraphs of the Response *qualify the extent to which I am obliged and permitted* to take the Ombudsman's Findings of injustice into account in determining the extent of relative losses suffered by classes of policyholders in respect of the Sixth Finding." (para 2.13)

116. It seems therefore that he himself regarded the **observations** as formal "qualifications" by the Government of its acceptance of the finding of injustice, which were binding on him and precluded him from reviewing the merits of the Ombudsman's own position on these points. This issue was not satisfactorily resolved in the pre-hearing correspondence, but in our view the position was put beyond doubt by Mr Lewis in his Summary statement which contained the following:-

"The Government recognises that both the Ombudsman's analysis and its own are matters of speculation. However, the availability of other possible options should be taken into account when assessing the impact and nature of the injustice. *Those are matters that Sir John Chadwick can consider*. He will, in accordance with paragraph 3 of his terms of reference, be able to make findings of fact as he may think necessary: that can include findings in relation to the availability of alternatives, the effect of that on the published solvency position and the effect on third parties." (emphasis added)

117. We take this as sufficient indication to Sir John that his remit is not as limited as he at first considered, and that he can look behind the Government's "**observations**" and form his own view of their merits. On that basis we need say no more about this ground of challenge.

The revised Terms of Reference issued in November 2009 after the judgement states "In relation to the injustice resulting from Equitable Life's use of reinsurance, the Government accepts that, because the regulator permitted credit to be taken for the reinsurance treaty, Equitable Life's returns gave a materially misleading picture as to its solvency".

*In March 2010<sup>18</sup> Chadwick considered that he was "required by the terms of the Ombudsman's findings to accept that from 1 May 1999 no properly informed policyholder would have decided to invest new monies. Subsequently in his final advice he:-*

*"...reconsidered the view reflected in those passages. As I have said, it is clear that I am not bound by the Government's view as to what would have happened if the FSA had not allowed Equitable Life to take credit for the Treaty in its regulatory returns for the year 1998. But it is equally clear, as it seems to me, that I am not obliged to take the Ombudsman's finding of injustice into account without qualification. I can make such findings of fact as I may think necessary in relation to the availability of alternatives, the effect of excluding credit for the Treaty on the Society's published solvency position and the effect on third parties (including, in particular, existing and potential policyholders)". (2.72)*

Chadwick claimed (1.40) that the Court made it clear that he was "not bound by the Government's observations: I can look behind them and form my own view of their merits. But there could be no purpose in being free to form my own view as to whether the possible options suggested by the Government might have had an effect on the published solvency position of the Society and the response of policyholders or prospective policyholders if I am bound by the Ombudsman's finding that all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999 suffered injustice. As it seems to me, I must advise on the basis that the Administrative Court took the view that I was not bound by that finding". In making this comment he has extended the scope of his remit from considering what was behind the government's **observations** qualifying the finding, to reconsidering the finding itself, never mind the government had accepted it. Unfettered he contrived a story based on what might have happened if Equitable had been properly regulated and there had been no need for the FSA to connive with Equitable's financial dishonesty:-

I have explained, also, why I am satisfied that it is open to me to differ from the Ombudsman's view that, if the FSA had not allowed Equitable Life to take credit for the Treaty in its regulatory returns for the year 1998, the ability of the Society to attract new investments after 1 May 1999 would have been greatly constrained. In fulfilling the task which I have been set by my Revised Terms of Reference, I can – and, indeed, must – consider "what would have happened" if the Society had not taken credit for the Treaty in its regulatory return for the year 1998. But in order to do so, I must take a view, and advise the Government on the question to what extent the regulatory returns for the years 1997 to 2000 would have been different if the maladministration which is the subject of the second, fourth, fifth and sixth Findings of

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<sup>18</sup> Equitable Life ex gratia payment scheme Third Interim Report": March 2010, paragraph 4.9.

maladministration (in so far as accepted by the Government) had not occurred. That is to say, I should not ask only the limited question “to what extent would the regulatory returns for the years 1990 to 1996 have been different if the maladministration which is the subject of the second, fourth and fifth Findings had not occurred”; I should go on to ask the more extensive question “to what extent would the regulatory returns for the years 1990 to 2000 have been different if the maladministration which is the subject of the second, fourth and fifth Findings and the sixth Finding had not occurred”. (3.5)

Towers Watson has addressed the Ombudsman’s sixth Finding of maladministration from the premise that (absent accepted maladministration) no credit would have been taken for the IRECO Treaty in the returns for the year 1998, or thereafter; and, that the true cost of obtaining reinsurance which provided a degree of risk transfer commensurate with the reduction in reserves shown would have been unacceptably expensive. **Accordingly, Towers Watson has calculated the change to the information presented by the Society in its regulatory returns for the years 1998 to 2000 on the basis that the liabilities of Equitable Life would have been larger by an amount equal to the amount of credit that was in fact taken for the Treaty. I accept Towers Watson’s advice on this issue. (3.49) (Emboldening added).**

I have given particular consideration to whether – in the light of the Ombudsman’s finding of injustice resulting from her sixth Finding of maladministration – it would be appropriate to conclude that there would have been a more substantial reduction in new investment income in the period after 1 May 1999. As I have said, I am satisfied that my Revised Terms of Reference permit me to form my own view as to what would have happened if the Society had not been permitted to take credit for the Reinsurance Treaty in its regulatory returns for the year 1998. In the light of the advice which I have received from Towers Watson, as described in Part 3, I have reached a view which departs from that of the Ombudsman. (7.64)

It is apparent from the figures shown in the Tables provided by Towers Watson that there would be no reason to draw a distinction between the position of Reconstructed Equitable Life in respect of the periods before and after 1 May 1999...This, to my mind, points strongly to the conclusions that I should depart from the Ombudsman’s conclusions that, if it had been unable to do so “its ability to attract new investments would have been greatly constrained” and that “the attractiveness of the Society as a potential investment vehicle would have been wholly undermined”. (7.65)

**Not surprisingly if there had been no need for the reinsurance treaty – which Towers Watson’s assumptions guaranteed - investors would not have lost money. But they were not investing in a fancifully Reconstructed Equitable, they were investing in actual Equitable. They are entitled to feel “outrage” for Chadwick’s sophistry of extending “looking behind observation” to embrace a complete review of the Parliamentary Ombudsman’s finding coupled with a “Reconstruction” whose basic premise was that there would have been no reinsurance treaty to mislead them. The exercise is nothing less than an intellectual scam.**

#### ANNEX 4: THE FABRICATION OF A “RECONSTRUCTED” EQUITABLE

1. The government asked Chadwick to consider “the extent to which the regulatory returns in each of the years for 1990 to 1996 would have been different if the maladministration accepted by the government had not occurred”.<sup>19</sup> Chadwick extended the exercise to 2000<sup>20</sup>. The first, and very important, point to note about this report is that it is limited in scope. Chadwick is not asked “how would Equitable have performed if it had been *effectively* regulated”, but only how might the returns have looked if the regulator had avoided the potential for maladministration. Actuaries Towers Watson proposed some of the secondary assumptions for the Reconstruction and undertook the modelling.

#### SOME OF WHAT THE PARLIAMENTARY OMBUDSMAN SAID ABOUT THE REGULATION OF EQUITABLE

2. Before considering how Chadwick proceeded it is important to see what the Parliamentary Ombudsman said under the heading “*The published returns were unreliable*”:-
  60. The first general consequence of the maladministration I have found is that the Society’s published **returns for each year from 1990 to 2000 were in important respects an unreliable source of information** about the financial position of the Society – about its exposure to guarantees, about the effects of its bonus policies, and about the solvency position which resulted from the determination of its liabilities and the valuation of its assets in a manner required by the applicable law.
  61. By saying that the regulatory returns were unreliable, I do not in every case suggest that the Society’s returns would have been found to be deficient had appropriate questioning by the prudential regulators and/or GAD taken place. However, the prudential regulators, acting with advice and assistance from GAD, had not verified that those returns were complete, accurate and in compliance with the requirements of the law. Those regulators could thus not have been satisfied that the Society’s returns showed its true financial position and were thus reliable.
  62. Those published returns materially understated the Society’s liabilities in several respects. That would have misled those seeking to assess the financial strength of the Society by considering those returns. Information in the returns was misleading and would have led those reading them to assume that the Society’s financial position was stronger than the position reported in the returns, when that was not the case.
  63. Anyone investing in the Society – whether as a new investor or as someone making a further investment in it – from the second half of 1991 onwards was at risk of being misled, if they had regard to the regulatory returns, about the financial condition of the Society. The prudential regulators permitted returns to be published which those regulators could not have been satisfied revealed the Society’s true liabilities or an accurate financial position.
  64. The extent of the failure to verify the Society’s financial position as shown in its returns began to become critical in the mid-1990s. Anyone reading the Society’s published returns for 1993 would not have been able from reading those returns to understand the implications of the fact that the Society had changed its bonus policy. Those reading later published returns did so without the benefit of adequate disclosure of the relevant issues which it was the responsibility of the prudential regulators and/or GAD to secure.

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<sup>19</sup> Conflated request under findings 2, 4 and 5 taken from Annex A, Advice to government in relation to the proposed Equitable Life payment scheme, J. Chadwick, July 2010.

Advice to government in relation to the proposed Equitable Life payment scheme, J. Chadwick, July 2010.

<sup>20</sup> Equitable Life: a decade of regulatory failure. Part one: Main Report, July 2008.

65. The failure by the Society and the prudential regulators and/or GAD to address relevant issues at this time was to have serious ramifications for the solvency position of the Society and for the reasonable expectations of its existing and potential policyholders.
66. From the second half of 1996 onwards, the Society's published returns should also have – but did not – disclose that the Society was in a very weak financial position. Had the Society been required at that time by the prudential regulators and/or GAD adequately to reserve for its guarantees, which were 'biting' by the time that the 1995 returns were submitted, the financial position of the Society would have looked very different to those considering investing in it.
3. Then under the heading "*Lost opportunities to address critical issues earlier*", she wrote:-
67. The second general consequence of the maladministration which I have found is that the Society and the prudential regulators, acting with the advice and assistance of GAD, **lost opportunities to address critical issues much earlier than they eventually addressed those issues.**
68. In relation to the widely accepted causes of the Society's closure to new business – a low free asset ratio, a policy of full distribution, a failure to reserve for generous and flexible guarantees, and the differential terminal bonus policy – these were all matters which the prudential regulators and/or GAD could have addressed through the scrutiny process in earlier years than 1998.
69. The Society disclosed information about those matters, although on occasion such disclosure was incomplete. Had the prudential regulators raised concerns with the Society at an earlier date, the resulting problems might have crystallised earlier and before they became so acute – thus mitigating or forestalling the impact of those problems on those who invested in the Society afterwards.
70. Some of those factors might have been ameliorated by earlier action but such action was not taken due to maladministration by the prudential regulators and/or GAD. Instead, they developed over time to become intractable. The postponed consideration of those factors and of the options open to the Society enabled the Society to continue to grow and to attract new business.
4. The Parliamentary Ombudsman summarised the failure to regulate in spite of the system of regulation having been enacted by Parliament<sup>21</sup>:
- "32 The central story of this report is that this robust system of regulation was not, in respect of the Society, implemented appropriately – that is, consistently, fairly, and with proper regard to the interests of those directly affected – by the prudential regulators and those providing assistance and advice to those regulators.
- 33 Assessing the risks relevant to a particular insurance company cannot be appropriately achieved through relying on its longevity or reputation.
- Verification of the financial position of such a company is not achieved if clear indications of difficulty or other warning signs are ignored or not followed through to a proper resolution. Ensuring that current and potential investors have sufficient information to enable them to make informed choices about their finances requires the published information about companies to be accurate and complete.
- 34 My findings in this report show that the prudential regulation of the Society during the relevant period failed – and failed comprehensively. That was not a system failure, but a failure properly

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<sup>21</sup> Op. cit., Chapter 15.

to implement in the particular case of the Society the system of regulation that Parliament had enacted.

- 35 Shared understandings as to the purpose of, and limits to, financial regulation and as to the relevant rights and responsibilities of all those affected by such a system depend on the proper implementation of Parliament's intention. That did not happen in this case."

#### THE MAIN ASSUMPTIONS BEHIND CHADWICK'S RECONSTRUCTION RELATING TO THE FINDINGS OF MALADMINISTRATION

5. For the fabrication of a counterfactual Equitable experience Chadwick made the following broad assumptions (3.9)<sup>22</sup>:-
- (i) that the management of Equitable Life would not have altered as a result of regulatory action;
  - (ii) that the management of Equitable Life would have sought to pursue the same business strategies as were actually pursued; and so would have resisted attempts by the regulators to procure that relevant decisions were taken which differed materially from the decisions actually taken; and
  - (iii) that the prudential regulators would have taken such steps (and only such steps) in relation to the matters which are the subject of accepted Findings of maladministration as were necessary to meet the legal and administrative obligations which the Ombudsman identified in her Report.

#### THE BEHAVIOUR OF EQUITABLE

6. Since the government did not accept the first finding of maladministration, namely that on being appointed Chief Executive in 1991 Ranson should have relinquished his role of Appointed Actuary, Chadwick can thus assume that under Ranson, with continuing inadequate actuarial check, Equitable would "have sought to pursue the same business strategies as were actually pursued. Thus it would have resisted attempts by regulators to procure that relevant decisions were taken which differed materially from the decisions actually taken" (3.11). He specifically mentions that Equitable would pursue policies of a "full distribution" together with informing policyholders about their total (i.e. guaranteed and non-guaranteed) bonuses, and not withholding surplus to build up an estate "for no identifiable purpose"<sup>23</sup>. Actuaries Towers Watson who were appointed by the Treasury to assist Chadwick<sup>24</sup> spelt out another implication of pursuing the same business strategies, commenting "... We have also assumed that, as is demonstrated by the following passage from the Penrose report, that Equitable Life's management were highly influenced by marketing factors and therefore where possible would have tried to continue to declare competitive levels of bonus... However the setting of the bonus rate was frequently influenced by marketing considerations and we assume this would also have been the case for Reconstructed Equitable Life". (153, 177).

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<sup>22</sup> Equitable Life Payment Scheme Advice to Government Actuarial Advice to Sir John Chadwick, Section Four, page[?].

<sup>23</sup> This phase was included in "With Profits Without Mystery", Roy Ranson and Christopher Headdon, presented to the Institute of Actuaries, March 1989.

<sup>24</sup> Equitable Life Payment Scheme Advice to Government Actuarial Advice to Sir John Chadwick Page 1 para 1.

7. What Ranson tried to do was to grow his way out of the problem of overbonusing by running a Ponzi scheme and hoping that growth of premiums and assets, together with growth of stock prices would pull his chestnuts out of the fire. Chadwick assumed Equitable would aim – and the Regulator would allow – roughly the same behaviour under the Reconstruction.

*Comment: in a letter to Chadwick dated 9 April, the current Chief Executive of Equitable, Chris Wiscarson, wrote<sup>25</sup>: It is entirely speculative to postulate whether Equitable would or would not have acted differently if the regulators had threatened to exert their full powers early in the process. If the regulator had concerns, it may not have been content with minimum adherence to the rules. One approach to persuasion would have been for the regulator to meet other members of the Equitable Life team. We understand that the regulator did not do that, but could easily have done so.*

*If one were to assume that the Society's management wanted to do what was best for the policyholders, being that the Equitable is a mutual, they may have been wrong in their approach but did not realise it. If the regulator had properly explained that they were wrong, it is quite possible that management would have taken the point fully on board and enthusiastically made significant changes to their approach. Instead, the regulator's failure to challenge may well have increased management's confidence in their approach.*

#### THE BEHAVIOUR OF THE REGULATOR

8. Next Chadwick considered the actions of the regulators. Although he stated (3.19):-

“It is necessary, therefore, to go beyond the assumption that the prudential regulators would have taken such steps (and only such steps) in relation to the matters which were the subject of accepted Findings of maladministration as were necessary to meet the legal and administrative obligations which the Ombudsman identified in her Report.”

he clearly intended the minimum regulatory effort. He began at the beginning as he intended to go on. He pointed out (3.29) that in 1999 when the regulators were faced with a decision whether or not to require re-publication of the regulatory return for 1997, the FSA decided not to because it had doubts about its power to force corrections to the returns. From this he concluded (3.31):-

“Consideration of the choice that was, in fact, made, in 1999, points strongly, in my view, to the conclusion that – had the maladministration which is the subject of the second, fourth and fifth Findings of maladministration not occurred – the regulator would not have attempted to force the Society to amend and re-publish regulatory returns that had already been published. It is much more likely that the regulator would have sought to secure a change in policy by the Society which would be reflected in the following year's regulatory return.”

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<sup>25</sup> VIII 21 et seq, Advice to government in relation to the proposed Equitable Life Payment Scheme, Supplementary Material (sections I to VII), J. Chadwick, July 2010.

9. Contrary to Chadwick's assumptions, the Parliamentary Ombudsman found that regulators did indeed seek changes to returns for other companies<sup>26</sup> (Page 215 of Part 1 of the Parliamentary Ombudsman report):-

"64 During the period covered by this report, there is clear evidence of the prudential regulators communicating with insurance companies, pursuant to the duty imposed by section 22(5) of the 1982 Act.

65 In respect of every year covered by this investigation, the insurance industry annual reports laid by Ministers before Parliament show that the duty to communicate to seek corrections to the returns led to the prudential regulators communicating with insurance companies on more than one hundred occasions in each year and, in most years that are relevant to this investigation, on many more occasions than this. Details are shown in Table 9a below."

The assumption Chadwick made enabled him to avoid considering any change to the 1990 regulatory return published mid-1991, which recorded the most egregious example of overbonusing (the total value of policies advised to policyholder was 28% in excess of asset value).<sup>27</sup> *Significantly this proposition reflected the view that the regulator would continue to make a mockery of the alleged basic regulatory principle of "freedom with publicity", in order to avoid frightening the horses – the investing public.* (It is noteworthy that Chadwick implies that the date when GAD became aware of overbonusing was in September 1992<sup>28</sup> when in fact concerns had arisen as a result of the scrutiny of the 1989 return<sup>29</sup> – unfortunately it would appear that the regulators failed to carry out any scrutiny at all for the previous two years<sup>30</sup>).

10. Most significantly Chadwick and Towers Watson tried to play down the significance of the regulator's duty to protect "Policyholders' Reasonable Expectation" (PRE) which was enshrined in the Insurance Companies Act 1982, in relationship to overbonusing. In his Third Interim Report published in March 2010 he wrote (2.24) "But my present view is that it cannot be said with any confidence that the shortfall of policy values as against assets (sic – he should have written the shortfall of assets as against policy values) would have been regarded as a sufficient, or necessary, basis for regulatory intervention. The regulations in force at the relevant time were not intended to address the relationship between policy values (which included both guaranteed and non-guaranteed benefits) and assets: they were intended only to address the relationship between guaranteed benefits and assets".
11. Wiscarson responded robustly<sup>31</sup> "Consideration of policyholders' reasonable expectations requires the regulators to do more than check the regulatory returns... Your assertion that the relation between

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<sup>26</sup> Op. cit., Chapter 9.

<sup>27</sup> Towers Watson wrote "GAD completed its detailed scrutiny of Equitable Life's 1990 year end regulatory returns in November 1991. By this stage the regulatory returns relating to the 1990 year end had been in the public domain for 5 months and would be superseded by the returns relating to the 1991 year end. On this basis we assume, as a Premise, that the regulator would have chosen not to require a republication of the 1990 regulatory returns and instead required an amendment to the 1991 returns. (94)

<sup>28</sup> 2.24 Third Interim Report.

<sup>29</sup> Penrose Chapter 16 paras 8ff pages 548ff.

<sup>30</sup> Penrose Chapter 16 para 7 page 548.

<sup>31</sup> Op. cit.

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assets and policy values was not the subject of regulation. As we said above, the concept of policyholder reasonable expectations was included in the Insurance Companies Act 1982 so it should have been of interest to regulators at least as part of their overall assessment.”

12. In his final report Chadwick avoided his previously ill informed view, and minimised reference to PRE. And Towers Watson provided him with wriggle room observing:-

“PRE is a term that is used in statute but is not defined there. Indeed, the Parliamentary Ombudsman did not believe that the regulator was under an obligation to consider PRE questions in a particular way. Different policyholders may have different expectations given the same information and the regulator at the time would not have had a well defined view of PRE with regard to Equitable Life.” (105)

“In principle, the regulator had the power formally to enforce companies to take account of PRE and could therefore have intervened in Reconstructed Equitable Life’s affairs by direction. But because PRE is not well defined in law it seems unlikely that the regulator would have sought to enforce a position on Equitable Life using statutory powers; and, in any event, the Ombudsman has made no finding to the effect that there was any maladministration in the failure to consider or take any formal enforcement action. But even if the regulator had sought to take formal action, we have assumed that (in line with Sir John’s Underlying Assumptions) the management of Reconstructed Equitable Life would have resisted any requirement to change its bonus philosophy or practice, including by threatening judicial review of any formal direction or order against it. Therefore the regulator would have acted through persuasion rather than direction. In this case the outcome of a dialogue between the regulator and Equitable Life would likely to have been a compromise”. (107)

*Comment: the approach assumes that under the Reconstruction the regulators would have hidden behind bureaucratic grey areas to pussyfoot as it did in real life. Yet the Parliamentary Ombudsman clearly criticised the regulators for not using the (ample) powers they had. PRE may not be well defined in law, but allowing investors to put money into a (Ponzi) fund where part of their contribution was going to pay out existing investors was definitely not part of their PRE. Furthermore it is surely part of a reasonable policyholder’s expectation that where a bonus is allocated to his policy there are actual assets to cover that bonus. **There can be no doubt about this matter.** And the claim that the regulators should have taken seriously any threat by the management of Equitable of a judicial review stretches credibility. The publicity of such a case would have exposed what Equitable was doing; would have stopped its overbonusing; and would have dramatically cut new premiums. The regulator should have at least threatened direction – “walk softly, but carry a big stick” – not pussyfoot with persuasion. The ineffectiveness of the regulator in dealing with the overbonusing in 1990 (when PV/A = 128%) was shown by the repeat overbonusing in 1994 (when PV/A = 114%). In like manner Reconstructed Equitable overbonused in 1994 (PV/A = 120%).*

13. The second Finding of maladministration was that GAD failed to scrutinize regulatory returns for each year from 1990 to 1993 re:-
- (i) the valuation rate of interest for discounting liabilities; and
  - (ii) the affordability and sustainability of bonus declarations.

According to the Parliamentary Ombudsman, this had the consequence that Equitable gave the impression that it was financially sound and able to pay generous bonuses. Towers Watson assumed in the Reconstruction that the regulator and Equitable would have agreed to modify subsequent valuation rates and the aggregate of policy values “into line with its total with-profit assets... over the course of the next five years” (3.37). But as Towers Watson’s figures show<sup>32</sup>, see below para 21, their Reconstruction failed to achieve that objective **over a decade except on one occasion in 1993 when the stock market peaked**. Furthermore this policy would not have provided a smoothing fund, which policyholders were led to believe existed<sup>33</sup> - for lack of maintaining a proper smoothing policy Ranson was expelled by the Institute of Actuaries. Chadwick assumes that in his Reconstruction this agreement would not have been made public to avoid frightening the investing public – again so much for “freedom with publicity”.

14. He could dispense with Finding 3 for which the government did not accept injustice that GAD failed when Equitable introduced its differential bonus policy in 1993:-

- (i) to inform DTI
- (ii) to raise the issue with ELAS
- (iii) to understand the rationale for the policy and how it was communicated to policyholders

The Parliamentary Ombudsman concluded the consequences of this finding were that (see Annex 1):-

- potential and existing policyholders making investments were not informed of the liability they might assume
- Equitable did not consider ring fencing new investors from the GAR risk
- Equitable was not required to begin reserving for GAR’s
- There were lost opportunities to test Equitable, and the problems that eventually brought down Equitable were obscured

Ignoring this maladministration resulted in Towers Watson commencing reserving a year too late for GARs.

15. Under the fourth finding of maladministration relating to the failure to reserve for GAR liabilities, Chadwick accepts there would have been a need to reserve in the regulatory returns for the years 1995 and thereafter. But as well as reserving too late (see above), Towers Watson reserved but

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<sup>32</sup> Equitable Life Payment Scheme Advice to Government Actuarial Advice to Sir John Chadwick Appendix C page A53 Table C.3.2. which only shows assets being sufficient to cover policy values by a tiny margin in 1993. The figure of 100% coverage in that table in 1999 is only arrived at by rounding down the actual figure to 100% rather than actually achieving it!

<sup>33</sup> For example the letter sent out in February 1994 advising policyholders of the bonuses for 1993 comments “The with-profits approach has the unique feature of smoothing out the fluctuations in the investment return which are associated with such assets”. This result can only be achieved with a smoothing fund which provides that over the years there is a balance on average between assets and liabilities not just occasionally achieving such a balance.

allowed insufficient reserves, namely £275 for 1995 and £325m for 1996. But by 1998 the GAR liability had grown to £1.6 bn.

16. The fifth finding of maladministration was that GAD failed in relation to regulatory returns for 1995:-
- (i) to check that ELAS's valuation was greater than the minimum required by Regulations
  - (ii) to do anything when aware that Standard & Poor's was misconstruing the returns and overstating the financial strength of ELAS

Chadwick accepted a technical point regarding (i); (ii) was not relevant for the Reconstruction.

17. Regarding the sixth finding, the scandal of the phony reinsurance treaty, in their Reconstruction Towers Watson assumed that the true cost of insurance could have been "prohibitively expensive". In consequence the regulatory returns for the years 1998 to 2000 were calculated "on the basis that the liabilities of Equitable Life would have been larger by an amount equal to the amount of credit that was in fact taken for the Treaty" (3.49). *Chadwick subsequently used the figures derived from this assumption to pretend that late joiners would not (under the reconstruction) have been dis-benefited by the falsification of returns resulting from the reinsurance treaty because there would not have been one – QED. But the approach was a tautology, so meaningless.*

Wiscarson commented on the hypocrisy of the Treasury which claimed to Parliament in 1998 that the regulator had very strong powers, yet when defending against maladministration it tried to show its powers were limited, see the Appendix to this Annex.

#### TOWERS WATSON'S FURTHER ASSUMPTIONS

18. Chadwick asked Towers Watson to accept the broad assumptions set out in 5 above and "to make such other assumptions as we consider reasonable in the circumstances" (9). Towers Watson made the following critical assumptions which Chadwick endorsed.

- (i) Regarding Equitable's overbonusing:-

"We assume that having seen that Reconstructed Equitable Life's APV ratio was well above 100%, the regulator would have engaged Reconstructed Equitable Life's management in a dialogue about how the APV ratio could have been brought down. The rationale for this is that with aggregate with-profits policy values well in excess of with-profits net assets, the regulator would have wanted to understand from the management of Reconstructed Equitable Life how it saw its business and bonus declarations developing over time, and in particular how it planned to address the high APV ratio." (106)

"In principle, the regulator had the power formally to enforce companies to take account of PRE and could therefore have intervened in Reconstructed Equitable Life's affairs by direction. But because PRE is not well defined in law it seems unlikely that the regulator would have sought to enforce a position on Equitable Life using statutory powers; and, in any event, the Ombudsman

has made no finding to the effect that there was any maladministration in the failure to consider or take any formal enforcement action. But even if the regulator had sought to take formal action, we have assumed that (in line with Sir John's Underlying Assumptions) the management of Reconstructed Equitable Life would have resisted any requirement to change its bonus philosophy or practice, including by threatening judicial review of any formal direction or order against it. Therefore the regulator would have acted through persuasion rather than direction. In this case the outcome of a dialogue between the regulator and Equitable Life would likely to have been a compromise." (107)

In assessing the likely conclusions of this dialogue [viz between the regulator and Equitable] we have borne in mind that "the regulations of the time did not place an explicit requirement on insurers to set their APV ratio to any particular level (and it was not common for insurers to manage their businesses through the APV ratio)". (108)

- Comments:*
- *It was not common for insurers to run their businesses without a free estate. Equitable was the only (major) company to do so and in addition for much of the 1990s Equitable allowed policyholders to exit non-contractually without paying a market value adjuster.*
  - *No other companies published total policy values.*
  - *No other companies published policy values. While they calculated the figure for internal purposes, they would adjust figures in light of circumstances and only informed policyholders of a figure when they exited.*

"Another part of the assumed compromise is that the regulator would not have sought to ensure that Reconstructed Equitable Life bring its APV ratio down to 100% immediately. To do so would have frustrated the PRE of existing members of Equitable Life. By reducing the APV ratio over a period, Reconstructed Equitable Life would have operated under a smoothing cycle that its policyholders could reasonably expect. We consider that pressure from the regulator to reduce the APV ratio over a short time frame would have been strenuously resisted by Reconstructed Equitable Life's management. It is not clear that such an approach would strike a good balance between ensuring bonuses are affordable and sustainable while meeting policyholders' expectations on accrued terminal bonus (even though this was not guaranteed). (114)

*Comment: this assumption entirely ignores the PRE of new investors whose initial payments were contributing to the money paid to exiting policyholders.*

(ii) Regarding PRE:-

"We have assumed that the regulator would have been concerned with PRE and that for Equitable Life these expectations included 'full and fair distribution'. However, the Parliamentary Ombudsman did not make a specific finding relating to PRE (although PRE forms part of the way that the regulator/GAD would view the affordability of Reconstructed Equitable Life's bonus rates in Sir John's interpretation of the Parliamentary Ombudsman's second and fourth findings). We have therefore assumed that the regulator would not have sought to change the behaviour of Reconstructed Equitable Life with regard to PRE. This would have allowed Reconstructed Equitable Life to continue to operate with a minimal estate during the 1990s." (167)

*Comment: but it should have operated with a smoothing fund. The Reconstruction did not include one.*

(iii) And PRE related to overbonusing:-

- that Equitable Life had created expectations around 'declared final bonus' (because uniquely in the market Equitable Life had informed its policyholders of the accrued value of final bonus);
- that Equitable Life had previously declared bonuses in excess of investment returns;
- that the fact that Equitable Life's APV ratio was well in excess of 100% might have constrained Equitable Life's ability to declare bonuses in future; and
- that new policyholders might have been misled about the future prospects for bonus rates. (102)

*Comment: there was no "might" about the last two propositions – the first one should be replaced by "should" and the second by "would".*

(iv) Regarding the valuation interest rate:-

The regulator/GAD would have been able to persuade Reconstructed Equitable Life's management that the margin should be no lower than 1.0%

Comment – this was a somewhat more stringent value than had been allowed to the Real Equitable,

(v) Continuing secret regulation:-

"We assume that the process of demonstrating that the 5 Year APV Projection process would have been a confidential matter between Reconstructed Equitable Life and GAD/the regulator... There is no reason to believe that either side would have regarded it as beneficial to put this information into the public domain. It would therefore not have been known to the potential or current policyholders. (121)

*Comment: "Freedom with publicity"!*

19. "We have set out below the key assumptions that we have made in setting the actions that we assume would have been taken by Reconstructed Equitable Life.

- Reconstructed Equitable Life would have been able to take credit for an implicit item in its regulatory returns up to  $\frac{5}{6}$ <sup>ths</sup> of its required minimum margin ("RMM").
- We assume that following the amendments made to the basis of preparation of its regulatory returns, Reconstructed Equitable Life would have compared its surplus/RMM cover to the average surplus/RMM cover of the bottom 5 competitors in the market. This average would have acted as a target minimum surplus/RMM cover for Reconstructed Equitable Life. We assume that strengthening actions would have been taken to the extent necessary to increase Reconstructed Equitable Life's surplus/RMM cover to the average of the bottom 5 competitors.
- We assume that following the discussion of Reconstructed Equitable Life's projected APV ratio with GAD, Reconstructed Equitable Life's management would have chosen to reduce its reversionary and/or final bonus rates.

- We have assumed that reductions in Reconstructed Equitable Life's EBR (compared with those of the actual Equitable Life at the same year end) would have affected its return on assets and the resilience reserve.
- We have assumed that reductions in final bonus rates (compared with those distributed by actual Equitable Life) would have reduced claims paid out. We have also assumed that Reconstructed Equitable Life would have set its final bonus rate to be more responsive to investment returns in the year to which the final bonus related. (163)

20. Towers Watson's assumptions were clearly consistent with the Treasury and Chadwick's wish to fabricate a Reconstruction that was as similar to Equitable's experience as possible.

### THE RESULTS OF THE RECONSTRUCTION

21. All of the assumptions made were clearly consistent with the Treasury's wish to fabricate a Reconstruction that was as similar to Equitable's actual experience as possible since the difference would impact significantly on the assessment of loss which Chadwick contrived – the smaller the difference, the smaller the "loss". The figures for the bonus rates and the ratio of aggregated policy values to asset values (PV/A) for the Reconstruction compared with the actual figures show they achieved this objective.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bonus rates												
The bonus rates for no reduction	12.0	8.5	8.5	13.0	8.0	9.5	10.0	13.0	10.0	12.0	3.3	-11
Actual bonus rates	121.0	12.0	10.0	13.0	10.0	10.0	10.0	13.0	11.0	12.0	3.3	-16
PV/A ratio												
Reconstructed PV/A ratio assuming 20% reduction in premium income <sup>34</sup>	128%	121%	112%	98%	114%	107%	107%	104%	102%	101%	109%	
Actual PV/A ratio	128%	125%	116%	102%	120%	112%	111%	107%	105%	103%	112%	

Sources: Tables 4.2, 4.3<sup>35</sup>, 4.4<sup>36</sup> of Towers Watson's report.

22. Chadwick drew the following conclusions:-

- the Society would have declared lower bonuses in some years during the period 1990 to 2000;
- the Society would have looked financially weaker prior to 2000 (but not significantly so) than it did, in fact, present itself;
- there would have been some reduction in premium income, both in respect of new policies and in respect of existing policies;
- ... the Society would have closed to new business at the end of 2000 (at or about the time that it did, in fact, do so following the decision of the House of Lords in the Hyman litigation and its unsuccessful attempt to sell its undertaking)."

<sup>34</sup> This scenario was chosen because Chadwick assumes a 20% loss of premium income when he is cutting the loss. There is, however, little difference to the other scenarios.

<sup>35</sup> Actual aggregate with-profits policy values and total net assets (derived from Penrose Table G.5)

<sup>36</sup> Reconstructed aggregate with-profits policy values and total net assets - Towers Watson estimate.

23. The Reconstruction is based on making assumption after assumption in favour of minimal regulatory action. Equitable would have continued for the whole of the 1990s to have overbonused except perhaps marginally for 1993; the regulators would have hidden many of their concerns from the public; Reconstructed Equitable would not have had a smoothing fund; it would not have dealt with the GAR problem adequately; and it would have collapsed when it did. *Such a performance is hardly an advertisement for Chadwick's view of how Equitable should have been regulated.*
24. Wiscarson commented to Chadwick regarding the Reconstruction<sup>37</sup>:-

“the counterfactual process that you have pursued in analysing what might have happened year by year is complex, deeply subjective and, most importantly of all, does not address the fundamental point that regulators failed to accumulate their knowledge in a way which could have made the eventual Equitable crisis predictable and therefore to a much greater extent avoidable.

The thrust of section 2 is that regulators responded to only the things that were within their remit and only in a short term fashion. There is a point which could have begun as early as 1990 when effective regulators ought, within their stated powers, to have been required to contemplate “what's the worst that can happen”.

#### WHAT EFFECTIVE REGULATION MIGHT HAVE ACHIEVED

25. The regulators could have acted forcefully in the early 1990s to address the two major problems faced by Equitable, - the overbonusing problem which they were informed of as early as 1990, and the guaranteed annuity rate problem of which they were aware in 1994:-
- The overbonusing problem could have been tackled by eliminating the reversionary bonus in 1990, as Ranson indicated when he flew a kite with the regulator suggesting he could wave the non-guaranteed bonus; but the regulator backed down. This would have had an enormous effect upon subsequent events. It would have improved Equitable's solvency position: acted as a warning to prospective investors that all was not well at Equitable; and it would have stopped the repeat performance of grossly overbonusing in 1994.
  - If the GAR problem had been tackled in 1994 there were then a number of options which the regulators could have suggested, but which were not available later. The GAR and non-GAR policies could have been segregated into two separate funds which would, quite properly, have placed the growing burden of the guarantee upon those whose policies contained that benefit. Non-GAR policyholders would have been protected, and the Hyman case would never have happened. Then:-
    - the GAR policy fund could have been reinvested largely in gilt-edged securities, which would have ensured that the guarantee could have been met. The non-GAR fund could have invested in an appropriate range of assets and should have done quite well out of the 1990s boom;
    - there would have been no need for the 1999 re-insurance policy.
26. A common factor in both these solutions to Equitable's fundamental problems is that they would have involved public acknowledgement that they existed. Policyholders and commentators would have noticed a big bonus cut for 1990 and the segregation of the fund in 1994, and many would have

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<sup>37</sup> Op. cit.

invested elsewhere. It is quite likely that the company would have survived the GAR problem. Assuming that it had also survived its overbonusing problem, which it might well have done if this had been tackled as early as 1990, Equitable might still be operating a real with-profits fund today.

## APPENDIX TO ANNEX 4 - TREASURY HYPOCRISY

When presenting its regulatory systems to Parliament, the Treasury reports on their extensive powers and effectiveness<sup>38</sup>. For example, in the Treasury's evidence to the Treasury Select Committee, Supplementary Memorandum from HM Treasury dated 16 October 1998, we read "However, the effect of section 45 is far greater than the formal exercise of the power suggests. In practice, companies who wish to make significant changes to their operations which might affect policyholders discuss these proposals in advance with Insurance Directorate; as a result of these discussions, proposals are either abandoned, or modified so as to be acceptable to the regulator. The existence of the power thus usually makes its formal exercise unnecessary."

In contrast, when defending against maladministration, the Treasury seeks to present the limitations to its powers:-

The Parliamentary Ombudsman conducted an assessment of the regulatory system, which comprises the whole of Part 2 of her report 'the regulatory regime'. The draft, supplied to the Treasury, produced the objections summarised in Chapter 9 of the main report. She rejects them. (pages 205 et seq).

It was suggested by Treasury Counsel to the Court at the application for judicial review that the Parliamentary Ombudsman's finding of injustice turned solely on the narrow issue of compliance with regulatory requirements. The Court rejected this submission. The court determined it was open to the Ombudsman to adopt a broader approach than the strict legal requirements, including having regard to issues of PRE.

"On 2 February 1981, in introducing legislation to implement the provisions of the first European Directive, subsequently to be consolidated within the 1982 Act, Sir Reginald Eyre, the then Minister responsible for prudential regulation, explained the approach to insurance regulation within the UK as being based on the doctrine of 'freedom with publicity' – like membership of the European Communities, another of the cornerstones of the system of prudential regulation covered in this report – and said:

*"Quite properly, the freedom I have referred to has its limits; the Secretary of State has a clear duty to intervene if it appears that all is not well. The need for supervision of the insurance industry is one of record. There have been cases in the past where failures of insurance companies have done policyholders and interested third parties great harm, and, indeed, done the industry no good. Although no system of supervision can avoid completely all risks of difficulty or failure of an insurance company, Government responsibility for a systematic approach is to be found not just in the United Kingdom, but throughout the countries of the developed world and in many others."*

Ample means to deliver the central aim of regulation, as articulated by all those Ministers –the protection of policyholders – were given by Parliament to those responsible for regulating the insurance industry."

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<sup>38</sup> The source of this script is from a letter from Chris Wiscarson to J. Chadwick, 9 April 2010, in Supplementary Material (sections VII to XII) of Chadwick's Advice.

## ANNEX 5: THE SEMANTIC TRAVAILS AND TRAVELS OF “ABSOLUTE LOSS” AND “RELATIVE LOSS”<sup>39</sup>

### Chadwick sets up Parliamentary Ombudsman’s wording as a straw man to manipulate

Chadwick starts off by observing (4.2) “The Ombudsman’s description of what she had in mind by “relative loss” appears, first, in the context of the four questions [of which two are shown] which, as she said, she would need to address before making any recommendations designed to remedy the injustice which she had found to have been sustained as a result of maladministration. Those questions were:-

“whether complainants have suffered a financial loss in absolute terms – that is, have they suffered an identifiable or quantifiable loss at all?;

if so, whether complainants have suffered a financial loss in relative terms – that is, have they suffered a loss that they would not otherwise have suffered had they invested or saved elsewhere than the Society?...”

He then observed (4.4) that she comments that “As for **absolute loss** I am very far from concluding that everyone who had complained to her about the prudential regulation of the Society has suffered a financial loss. Still less do I conclude that everyone who has saved with, or invested in, the Society during the period covered by this report has suffered financial loss.” He commented “She recognised that some had benefited from overbonusing in the 1990s, but recognised “that those who are, or were at the relevant time, members of the Society underwent the series of policy value and bonus cuts during the period after it closed to new business.” (4.5)

### Inferences, insinuations and twists

Chadwick inferred “that, before she could make a recommendation for financial compensation in any individual case, she would need to be satisfied that those who had complained to her, and those who had been affected in the same way by the same maladministration, had sustained injustice in the form of financial loss as a result of that maladministration – that policyholders in the class just described would not qualify for financial compensation.” (4.6)

*Comment: this is an unjustified inference from the Parliamentary Ombudsman’s approach of excluding entirely those who benefited from overbonusing by exiting before the 16 July 2001 cuts; she was advocating the simple concept of “relative loss” for those who were in Equitable on and after 16 July 2001.*

Chadwick then observes (4.7) “The Ombudsman’s answer to the first question – “have complainants suffered a financial loss in absolute terms – an identifiable or quantifiable loss” is found in the passage immediately following that which I have just set out:-

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<sup>39</sup> The para numbers refer to his Advice – his explanation is in Part 4, The Quantification of Relative Loss.

*“That is sufficient evidence in my mind to persuade me to conclude that, for many people at least and in a context where those people had reasonable expectations concerning their policy values and bonuses, financial loss has been sustained...”*

Chadwick now claims (4.7) “As I have said I do not find that reasoning easy to follow. The cuts... did not affect guaranteed bonuses: they were restricted to cuts in final bonuses (which... were not guaranteed). The policy value cuts applied by the Society following closure to business at the end of the year 2000 did not deprive policyholders of moneys to which they were contractually entitled. The policy value cuts were applied in such a way that only those who withdrew their funds other than on the contractual terms of their policies (and, indeed, only some of those) would have suffered an “absolute loss” in the strict sense: that is to say, in the sense that they received back from the Society, on withdrawal, a smaller sum than that which they had paid to the Society in premiums.” (4.7)

*Comment: perhaps he is finding her reasoning difficult to follow because he is contriving to twist her meaning.*

He next claims (4.8) that “To understand what the Ombudsman had in mind, it is necessary to read the two passages together:-

*“... the fact that those who are, or were at the relevant time, members of the Society underwent the series of policy value and bonus cuts during the period after it closed to new business ... is sufficient evidence in my mind to persuade me to conclude that, for many people at least and in a context where those people had reasonable expectations concerning their policy values and bonuses, financial loss has been sustained...”*

“For reasons which I have explained I find it difficult to see how it can be said that the policy value cuts amounted to “absolute losses” for policyholders: comparable, say, to the losses that would be suffered from the failure of a bank or building society to repay to a depositor money on deposit. The effect of the policy value cuts was to give rise to disappointed expectations: but, as it seems to me, it cannot properly be said that (save in exceptional circumstances) the policy value cuts caused financial losses “in absolute terms”.”

*Comment: in the Parliamentary Ombudsman’s approach of “relative loss” by comparison, “expectations” come out in the comparative wash, so introducing the concept of expectations is otiose. Further the supposed contrast with money on deposit with a bank is false. If someone deposited money with a bank (s)he would reasonably expect say ten years later to have accumulated deposit interest on the account and in the event of the bank’s failure then his entitlement to compensation would include that deposit interest as well as his original deposit. Similarly with an insurance company the compensation would include what the policyholder reasonably expected which includes non-guaranteed bonuses allocated to his policy in respect of which the policyholder had been informed annually. This PRE was effectively guaranteed by the insurance statutes.*

Chadwick then (4.9) points to her second question, and in a striking non-sequitur concludes (4.10) “It is, I think, plain that (at that stage in her analysis) the Ombudsman had in mind that, in order to determine whether a policyholder has suffered “relative loss”, it would be necessary to ask each of the first two questions which she had posed earlier:-

- (i) whether the policyholder had suffered a financial loss in absolute terms in respect of his investment with the Society; and
- (ii) if so, whether that financial loss would have been suffered if the policyholder had invested elsewhere.

The effect of this approach is that the answer to the first question provides a ‘cap’ to the calculation of “relative loss” - “relative loss” cannot exceed the amount of “absolute loss”: it must be less than or equal to that amount.”

*Comment: now he is getting where he wants to.*

He now moves to another pinhead to consider the possibility of “relative loss” without “absolute loss”. He first notes how the Parliamentary Ombudsman cites with apparent approval the compensation award in a Financial Ombudsman case where (4.12) “*compensation is to be assessed by comparing the return Ms E received on the money she put into a with-profits pension with Equitable Life and the return she would have received from a similar product with an alternative provider.*” The Parliamentary Ombudsman concluded (4.13) “... *it seems to me that this demonstrates that, for many of those covered by my recommendations, it could be established that a loss had been sustained, relative to what would have transpired had those individuals saved or invested with a comparable with-profits fund.*”

Chadwick then exercises his imagination (4.14):-

“I have asked myself whether, in the course of considering the second of the four questions which she had posed for consideration in deciding what remedy to recommend in respect of financial loss... there is a shift in the sense in which she uses the phrase “relative loss”. That is, did she consider “loss which would not have been suffered had they saved or invested elsewhere” to be the same, or to differ from, “loss relative to what would have transpired had those individuals saved or invested with a comparable with-profits fund”?”

*Comment: the claim that “there is a shift in the sense” is specious.*

Now, in a continuing set of hair splitting sophisms, he fabricates an argument that the Parliamentary Ombudsman is excluding those who benefited from overbonusing from compensation “because they could not be said to have suffered a financial loss”, so (in a non-sequitur) he claims she intends a two-stage test for all. He alleges “it is difficult to see how the Ombudsman could have thought that policyholders in that class could be excluded from financial compensation if what she had in mind was a single stage test under which the only question to be asked was: “what return a policyholder would have achieved if, instead of investing in

Equitable Life, he had invested in a comparable product offered by an alternative provider". (4.18) Since "there are likely to be policyholders to whom the 2001 cuts did not apply... who have gained from the bonuses declared by the Society during the 1990s: but who would have gained even more if they had invested elsewhere... This, as it seems to me, reinforces the conclusion that, in referring to loss sustained "relative to what would have transpired had those individuals saved or invested with a comparable with-profits fund" she is not to be taken as having intended to remove the 'cap' imposed by "absolute loss". (4.19)

*Comment: Chadwick appears to be logically challenged. The Parliamentary Ombudsman clearly intended the single stage test mentioned above, that Chadwick rejected.*

With further twisted and tortuous logic he concludes that "relative loss is suffered (and suffered only) by those who have suffered financial loss" (4.24). So he now goes on to consider "Financial loss in absolute terms" (4.26) as posed by the Parliamentary Ombudsman in her first question. To this end he considers "what were the reasonable expectations which the Ombudsman considered to have been frustrated?" (4.28) Focusing on the policy cuts of 2001 and the succeeding cuts to with-profits annuities in 2003, he repeats (4.31) that "the 2001 cuts did not affect policyholders' guaranteed entitlements. Where policyholders have left the Society contractually after the application of the cuts, they have received the entirety of their guaranteed benefits. It is only those who have left non-contractually who will have received less than the sum which would have been guaranteed if they had maintained their policies until maturity or the point at which they were contractually entitled to surrender them."

*Comment: we are now in Wonderland.*

With glee he notes (4.37) that the Parliamentary Ombudsman observed "[A]ny losses associated with the July 2001 policy value cuts are not exclusively attributable to the maladministration which I have found to have occurred but that such maladministration was one among many contributory factors to those losses." Then with another leap of logic he comments (4.39):-

"I am satisfied that in Chapter 14, the Ombudsman was proceeding on the basis that the complainants' submission was that the 2001 cuts suffered constituted the loss – that is, the absolute loss, or financial loss – which had been suffered as a result of maladministration... But, as the Ombudsman had concluded in Chapter 12 of Part One, those cuts were due to maladministration only in part; the cuts were also, in part, attributable to other matters. It would be inexplicable if, having determined in Chapter 12 that the 2001 cuts were only partly due to maladministration, the Ombudsman had in Chapter 14 reached the view that all policy value cuts applied since the closure to new business – and not only those applied in July 2001 – should be treated as constituting financial loss suffered as a result of maladministration. Rather, it seems to me that the Ombudsman had in mind that an assessment of "relative loss" would extend only to that part of the July 2001 policy value cuts which was attributable to maladministration."

*Comment: we are way Through the Looking Glass.*

With a further stretch of logic Chadwick observed (4.41) “It is apparent, then, that the Ombudsman did not simply assume that any cuts experienced since the Society’s closure to new business constituted “absolute loss”; and, once the principle is established that only some cuts qualify, it is natural to restrict that class of cuts which did amount to “absolute loss” to the 2001 cuts, about which complaint had been made.”

“Finally, I have in mind that, as I have already explained, the Ombudsman may be taken to have had in mind compensation payments which went beyond the scope of what many would understand to be “absolute loss” in the context of the failure of a financial institution: that is, compensation payments to cover not only policyholders’ actual losses but also their disappointed expectations. Any payment of public funds to fulfil a disappointed expectation of gain, rather than to redress a loss, would, in my view, require a strong justification; and I would expect the Ombudsman to have used clear words in making such a recommendation. Therefore, the fact that it is not clear that she had in mind anything beyond the 2001 cuts as constituting “absolute loss” constitutes, in my mind, a good reason for concluding that this was all she had in mind. (4.42)

So now (4.44) “In the remainder of this Part of my Advice, I explain how “relative loss”, in the Ombudsman’s sense, is to be assessed. In the remainder of my Advice, I shall refer to relative loss, in the sense employed by the Ombudsman, as “External Relative Loss”. .

*Comment: Now he is making it up - what a recommendation for the judiciary!*

## ANNEX 6 - REDEFINING “RELATIVE LOSS” AND CONTRIVING “INTERNAL RELATIVE LOSS”

### 1. THE PARLIAMENTARY OMBUDSMAN’S CONCEPT OF RELATIVE LOSS

The Parliamentary Ombudsman’s concept of “relative loss” was set out in Chapter 14 of her main report. She refers (3) to her reports “Principles for Remedy” and “Principles of Good Administration” which sets out her “underlying principle to seek to ensure that the relevant public body restores the complainant to the position he or she would have been in, had the maladministration not occurred” (5). In (27) she defines “financial loss in relative terms – that is, they have suffered a loss that they would not otherwise have suffered had they invested or saved elsewhere than in the Society”. She states (33) “That brings me to relative loss” and cites (34) “... that the approach that the Financial Ombudsman Service takes to the question of remedying financial loss is a comparative approach” and quotes the case of Mrs E where the Financial Ombudsman concludes “Therefore, compensation is to be assessed by comparing the return Mrs E received on the money she put into a with-profits pension with Equitable Life and the return she would have received from a similar product with an alternative provider.”

Finally (138) **her second–and central–recommendation is that the Government should establish and fund a compensation scheme... [whose aim] should be to put those people who have suffered a “relative loss” back into the position that they would have been in had maladministration not occurred.** (For the avoidance of doubt she mentions the accumulation of interest (26), which Chadwick acknowledges (4.3)).

Towers Watson calculated this meaning of “relative loss” at £4.0 - £4.8bn, which was an underestimate because 1) the period July 1991 to December 1992 was cut off; and 2) we think that the method used to calculate the returns from investing in the comparators underestimated by £1bn or so. We will not, however, know these points until we are favoured with Treasury transparency.

The Parliamentary Ombudsman saw that the alternative methodology of looking at loss derived from individual acts of maladministration as involving far too many assumptions (as Chadwick and Towers Watson comprehensively demonstrated with Reconstructed Equitable!), and that relative loss could be used:-

- (1) for those who had lost money in absolute terms, i.e. late joiners
- (2) for those who suffered loss over a period long enough to expect a reasonable investment return , i.e. everybody else
- (3) for those who suffered 'loss of opportunity' (premiums 1991-1998), with a discount
- (4) for those who suffered loss, without a discount, on investments made after May 1999 due to the phony reinsurance treaty.

As described in the following sections, Chadwick set to work to cut “relative loss” first by reinterpreting the Parliamentary Ombudsman’s definition and calling it “External Relative Loss”, and second by creating a completely specious new concept which he calls “Internal Relative Loss”. He then combined them into a

weighted composite, but not until he had applied a discount figure based on the proportion of revenue he made up that Equitable might have lost from people shifting their premiums elsewhere. The effect was to reduce Towers Watson's £4-4.8bn by 90% to £400-500m

## 2. "ABSOLUTE LOSS"

Chadwick early on acknowledges "I recognise, that the Parliamentary Ombudsman's Report is intended for a lay readership. It is not a legal instrument; and it should not be subjected to the analysis and strict interpretation that would be appropriate to a legal instrument... (2.8). Nonetheless in Part 4 (with hair splitting pedantry and a level of sophistry that is no credit to the legal profession) Chadwick nano slices and dices the Parliamentary Ombudsman's scripting supposedly (as he puts it) "To understand what the Ombudsman had in mind" (4.8). .

He claims (4.10) "it is, I think, plain that (at that stage in her analysis) the Ombudsman had in mind that, in order to determine whether a policyholder has suffered "relative loss", it would be necessary to ask each of the first two questions which she had posed earlier:

- (i) whether the policyholder had suffered a financial loss in absolute terms in respect of his investment with the Society; and
- (ii) if so, whether that financial loss would have been suffered if the policyholder had invested elsewhere.

The effect of this approach is that the answer to the first question provides a 'cap' to the calculation of "relative loss". "Relative loss" cannot exceed the amount of "absolute loss": it must be less than or equal to that amount."

Leading Counsel Anthony Boswood QC comments "*Certainly, I find myself at present at a loss to understand paragraph 4.10 of Sir John's Report as quoted by Mr Bellord: if a given policyholder can prove he has suffered an absolute loss, and a relative loss as well which is higher, why should the former operate as a cap on the latter?*"<sup>40</sup>

Unfortunately Chadwick's literary skills do not extend on pages 109-112 to providing a comprehensible description of "absolute loss". The clearest statement is in Towers Watson's side letter to Hoban of 21 July:-

"Absolute loss is derived as the difference between the payout (allowing for the guarantees in the policy terms) that would have been received (or would have been received in the future) by the policyholder in respect of the relevant Equitable Life policy, if the final policy value cuts of 2001 and with-profit annuity cuts in 2003 had not occurred and the payout which has actually been received (or will be received in the future), in respect of the Equitable Life policy. The estimate is the aggregate across all policies".

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<sup>40</sup> Letter to Stephen Grosz, 22/8/2010.

Mark Hoban commented in Parliament<sup>41</sup>:-

“Let me remind the House that the ombudsman considered that the financial loss suffered by policyholders was a consequence of the reduction in policy values in July 2001. These amounted to a reduction in the gains they expected to make from their policies, rather than the sums they were contractually entitled to. As a result, Equitable Life's policies are lower in value today than they would have been without these cuts. The difference is the absolute loss, which Towers Watson estimates as being between £2.9 billion and £3.7 billion.”

**It is noteworthy that:-**

**The Parliamentary Ombudsman did not state that the financial loss suffered by policyholders was just a consequence of the reduction in policy values in July 2001.**

**The point about “gains expected” is subsequently used by Chadwick to claim that taxpayers should not pay for loss of expectations.**

**Presumably the reason why this irrelevant concept was introduced was to incorporate it into the “External Relative Loss” cutting formula.**

### 3. CHADWICK’S PERVERSE REDEFINITION OF “RELATIVE LOSS”

In ten tightly packed pages (112-121) of dense, often misleading and specious semantic gymnastics<sup>42</sup> Chadwick reinterprets the Parliamentary Ombudsman’s meaning of “relative loss” by taking it apart into bits, and examining the bits in order to see where and how he can cut it.

Chadwick notes that the Parliamentary Ombudsman identified some policyholders had benefited from overbonusing in the 1990s and should not be included in a compensation scheme. He then generalises from these policyholders claiming that supposedly “before she could make a recommendation for financial compensation” that the policyholder “had sustained injustice in the form of financial loss”. Chadwick claims “I do not find that [Parliamentary Ombudsman’s] reasoning easy to follow” (4.7), perhaps because one might think he was contriving to twist her meaning. He proposes that “there is a shift in the sense she used “relative loss” (4.14), a shift that is in his mind’s eye. Following more hair splitting sophisms he concludes (4.18) “In referring to loss sustained “relative to what would have transpired had those individuals saved or invested with a comparable with-profits fund” she is not to be taken as having intended to remove the ‘cap’ imposed by “absolute loss”.” With further twisted and tortuous logic he states “relative loss is suffered (and suffered only) by those who have suffered financial loss” (4.24). Then with further leaps of logic he commented (4.39):-

“I am satisfied that in Chapter 14, the Ombudsman was proceeding on the basis that the complainants’ submission was that the 2001 cuts suffered constituted the loss – that is, the absolute loss, or financial loss – which had been suffered as a result of maladministration... Rather, it seems to me that the Ombudsman had in mind that an assessment of “relative loss” would extend only to that part of the July 2001 policy value cuts which was attributable to maladministration.”

<sup>41</sup> Column 576, Hansard, 22 July 2010.

<sup>42</sup> Chadwick appears to have a problem in that he is a wordsmith rather than a numerate man. Just as a picture can be worth a thousand words, so a few numbers can illustrate a principle more clearly than long strings of text. They moreover enforce mental discipline to show how something can – or cannot - be measured. (In Chadwick’s case, there is scarcely a number in his report – the summary loss numbers are in a side letter from Towers Watson to Hoban!).

**Nothing can be further from the truth – “relative loss” as the Parliamentary Ombudsman meant it encompasses not only that part of the policy cuts related to maladministration, but also poor performance in the 1990s due to the maladministration of allowing overbonusing in 1990 and 1994 resulting in underperformance in other years<sup>43</sup>, and loss from market value adjusters. Her essentially simple approach embraces all of these factors.**

So now (4.44) “In the remainder of this Part of my Advice, I explain how “relative loss”, in the Ombudsman’s sense, is to be assessed. In the remainder of my Advice, I shall refer to relative loss, in the sense employed by the Ombudsman, as “External Relative Loss”. **What rubbish - no wonder the Parliamentary Ombudsman disowned it!**

#### 4. THE CASH CONSEQUENCES OF CHADWICK’S DEFINITION OF EXTERNAL RELATIVE LOSS

In order to assess “External Relative Loss” Chadwick states (4.46) “... it is necessary to carry out a two-stage process:-

(i) First, it is necessary to determine the difference between:-

- (a) payout (allowing for any guarantees in the policy terms) that would have been received (or would in the future be received) by the policyholder in respect of the relevant Equitable Life policy if the final policy value cuts of 2001 and WPA (with-profit annuity) cuts in 2003 had not occurred (**call it amount A**)
- (b) the payout which has actually been received (or which will in the future be received) in respect of that Equitable Life policy” (**call it amount B**)

(Chadwick terms this “Absolute Loss”).

(ii) “Second, it is necessary to determine the difference between:-

- (a) the payout which would have been received (or would in the future be received) in respect of a comparable product offered by an alternative provider (**call it amount C**)
- (b) the payout which has actually been received (or will in the future be received) in respect of that Equitable Life policy” (i.e. **amount B**)

(This is the ‘relative loss’ recommended by the Parliamentary Ombudsman.)

Chadwick continued “External Relative Loss would be determined as the lower of (i) and (ii). Where (ii) is greater than (i), “absolute loss” – measured by (i) – imposes a cap”. (637)

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<sup>43</sup> Because of overbonusing in 1990 and 1994 (and earlier) Equitable’s returns to policyholders were poor during most of the 1990’s as it attempted to get its policy values into balance with assets. This is shown in Towers Watson’s Table 6.5 which compared the policy payouts of Equitable and five other providers. Towers Watson’s comment (311) “The payouts on Equitable Life’s policies were, on average, lower than the payouts of the comparators [particularly for the 10 year policies]... This is despite the investment performance of Equitable Life being similar to the comparators. It should be noted that these were not the top six performing companies in 2000. **This under-performance is part of the maladministration for many policyholders.**

External Relative Loss can be reformulated as the lower of:-

$$A - B \text{ and } C - B$$

In the very likely event that C is greater than A, then External Relative Loss is generally =  $A - B$ , **a piece of algebra which disposes with the Parliamentary Ombudsman's concept of Relative Loss (C-B) and in most cases replaces it with Absolute Loss.**

The effects of these two stages are illustrated by the following example of a hypothetical policyholder who invested £10,000 in a pension policy at the beginning of 1995 then by Dec 2000 the total policy value was £16,531. On 16 July 2001 it was cut by 16% (£2,645) leaving £13,886 which was taken on a contractual exit without suffering any penalty. If the person had invested in Elsewhere Life, his fund would have been worth £18,668.

The first stage is:

	£
What (s)he would have got if the 16% cut had not occurred	16,531
What (s)he did get	13,886
Absolute loss	2,645

The second stage is:

What (s)he would have got from Elsewhere	18,668
What (s)he did get	13,886
Relative Loss	4,782

'External Relative Loss' is the lower of the two and equals 2,645

By this definition, the Parliamentary Ombudsman's Relative Loss has been reduced by £2,127 (i.e. £4,782 - £2,645).

**Towers Watson estimated External Relative Loss as £2.3 - £3.0bn.** Hoban commented in Parliament (without mentioning the concept):-

"For a number of policyholders, because of the strong performance of comparable life companies, their relative loss is greater than the absolute loss they suffered. Consistent with the ombudsman's recommendation, Sir John has advised that relative loss for an individual policyholder should be capped at the absolute loss they suffered. It is hard to see how it would be fair either to the taxpayer or to other policyholders if some policyholders received more through redress than they had actually lost. If the proposed cap is adopted, then the figure will be £2.3 billion to £3 billion."

**It is noteworthy that:-**

- **The Parliamentary Ombudsman clearly recommended compensation for relative loss.**
- **She most definitely did not recommend capping.**
- **The very debatable statement about fairness to the taxpayer eliminates her principle of relative loss in the majority of cases.**

## 5. INTERNAL RELATIVE LOSS

Next Chadwick assesses “what I shall describe as the “Internal Relative Loss” suffered by each policyholder”. He comments (6.17):-

“With these matters in mind, in my view it is appropriate to add to the assessment of loss actually suffered an element to take account of what I have called “Internal Relative Loss”. Internal Relative Loss is the loss suffered by a policyholder because the return that he has received (or will receive) in respect of his Equitable Life with-profits policy is less, in the events which have happened, than it would have been had the Society been regulated during the period covered by the Ombudsman’s investigation without the maladministration which the Government accepted. That is to say, it is the loss suffered by a policyholder as a result of the effect which the accepted maladministration had on the business of Equitable Life: in contrast to the loss (External Relative Loss) which the policyholder suffered as a result of not choosing to invest elsewhere.”

He then (6.18) “considers” – and of course concludes “yes” – whether his terms of reference permit him to include an assessment of Internal Relative Loss. Following a further convoluted page he claims (6.23):-

“After further reflection, I have reached the view that a possible explanation for the Ombudsman’s failure to refer to Internal Relative Loss lies in the fact that she was not able to make findings regarding the actions of persons other than the public bodies which she investigated. It would not have been open to her, therefore, to reach the conclusion that but for the accepted maladministration, there would necessarily have been any policyholders whose investments in Equitable Life with-profits policies would have performed better than, in the events which happened, they did. In order to reach that conclusion, the Ombudsman would have had to find that, but for the accepted maladministration, the Society would have declared lower bonuses during the 1990s than, in fact, it did: and that finding was not within her remit.”

He then goes on through a further 3 pages of dense wordsmithing to assess Internal Relative Loss, as the difference between (6.3):-

- (c) what the policyholder would have received (or would in the future receive) in respect of his investment in Equitable Life with-profits policies if, in the regulation of the society, the maladministration which the government accepted had not occurred (**call this amount D**);
- (d) what the policyholder has received (or will receive in the future) in respect of his investment in Equitable Life with-profits policies in the events which happened (i.e. **amount B**).

The Internal Relative Loss =  $D - B$  because under the Reconstruction, while bonuses were somewhat lower over the period to closure, there would still have been a cut of 11% and so  $D > B$ .

**Internal Relative Loss is a completely fictitious concept whose sole purpose is to cut his assessment of loss.**

[For most policyholders who invested after 1990 (which is the overwhelming majority as can be seen from the fact that the with-profits fund increased from £4.8bn in 1990 to £25.6bn in 1999<sup>44</sup>) returns were poor as shown by Towers Watson<sup>45</sup>. During this period Equitable marketed its products based on the relatively

<sup>44</sup> Table 4.3 of Actuaries Advice to Chadwick, Towers Watson.

<sup>45</sup> Table 6.5 compared the policy payouts of Equitable and five other providers. Towers Watson comment (311) “The payouts on Equitable Life’s policies were, on average, lower than the payouts of the comparators [particularly for the 10 years policies]... This is despite the investment performance of Equitable Life being similar to the comparators. It should be noted that these were not the six top performing companies in 2000.”

favourable returns of policies accumulated over a previous long period (e.g. 20 years). Such policies had benefited from the good years of 1980s when the reserves were run down, and also the gross overbonusing of 1990 and 1994. Those who invested subsequently – particularly after 1994 - achieved relatively poor returns because Equitable was more cautious with its bonus declarations as it aimed to close the gap between the aggregate of policy values and asset value.]

## ANNEX 7 – COUP DE GRÂCE

There are two further steps to go on Chadwick's cutting, namely first to make a deduction for policyholders who would not have moved on the grounds that since it is not possible to assess individual cases a "wholesale" approach is needed. Then second is to apply the discounting to External Relative Loss and Internal Relative Loss.

### 1. MINIMISING THE PROPORTION OF POLICYHOLDERS WHO MIGHT HAVE LEFT EQUITABLE

Chadwick indulges in a lengthy discourse (including some gratuitous criticisms of the Parliamentary Ombudsman) to make the obvious point that to attempt individual loss assessments based on who took how much notice of publications about Equitable more than a decade ago is not practicable. Chadwick claims that "... the fairest practical way of assessing External Relative Loss would be to treat all who invested in the Society during the relevant period as having suffered External Relative Loss, but to discount the loss so assessed by a proportion equal to the proportion by which the premium income received by the Society during the relevant period would have been reduced absent maladministration."<sup>46</sup> So he sets about assessing that proportion, which he wants to make as small as possible. A critical point is that it is "absent maladministration". As we see in the Reconstructed Equitable and in Annex 4, the Reconstruction absent maladministration was devised so that returns were only marginally different to those actually achieved. Consequently the reduction in income and hence the proportion of policyholders who would have switched to alternative providers – hence reduced premium income - would likely be small. He has several further stories to substantiate this latter point:-

- He sets out the credit ratings by Standard & Poor's and Moody from Autumn 1993 to early 2002, and notes that "S&P did downgrade the Society's rating from AA to A+ in May 1999; but this does not, by itself, appear to have had a substantial impact on the new premiums received by the Society. This suggests that, if S&P had attributed a lower rating to the Society at a time earlier than May 1999, the Society's premium income would not have been substantially affected" (7.23).

*Comment: He conveniently ignores the Parliamentary Ombudsman's fifth finding of maladministration relating to the regulators allowing Standard & Poor's in 1995 to publish a rating based on a misconception of the regulatory return, of which the regulator was aware. If Standard & Poor's had known the truth about Equitable's financial position their ratings (and hence those of other rating agencies) would have been much less favourable.*

- He makes much of the fact that Equitable's policy of "full distribution" (which was a reason for Equitable's financial position being weaker than its competitors) was widely known (7.9 et seq). But he does **not** mention during this part of his study that Equitable was over-distributing, nor that his Reconstructed Equitable over distributed across the 1990s. Furthermore as noted earlier policyholders were led to believe that Equitable was maintaining a smoothing fund, which it was not. GAD was aware of the overbonusing from 1990 and should have been aware of the lack of a smoothing fund. Chadwick claims in his Third Interim Report (224) that the DTI was not aware of overbonusing until September 1992 – the Parliamentary Ombudsman points out that the regulators knew before 1990 ended that Equitable was in difficulties and was considering not paying a reversionary bonus for that

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<sup>46</sup> The EMAG suggested this approach to the Parliamentary Ombudsman based on experience of loss evaluation in commercial litigation cases and the practice of the Courts in dealing with 'loss of opportunity' following the Court of Appeal decision in *Chaplin v Hicks* 1911.

year.<sup>47</sup> Furthermore Chadwick's opined that there was no obligation on the regulators to tell the public that Equitable was overbonusing.

*Comment: If the regulators had been doing their job properly and been concerned about the PRE of new investors and implementing "freedom with publicity" they would have both acted and made Equitable's position public. Investment would have dried up.*

- He "was not persuaded that, if the free asset ratio had been lower by approximately the amounts reflected in the regulatory returns for Reconstructed Equitable Life that would have been seen by policyholders and prospective policyholders to have had a materially adverse affect on solvency. In reaching this view, I have considered whether Reconstructed Equitable Life's modest reductions in its published free assets would have pushed it over a "tipping point" in public confidence, along the lines described in paragraph 7.14 above. That such a "tipping point" would have been reached is, in my view, most unlikely" (7.56).

*Comment: this proposition is undoubtedly true since the free asset ratio<sup>48</sup> was not that much lower for Reconstructed Equitable than Real Equitable – which was a direct consequence of the weak regulatory assumptions made for the reconstruction.*

- "... Investors were attracted to Equitable Life by its low expense ratio, its mutual status, the flexibility of its products and the bluechip nature of its reputation. Even the sustained criticism of the Society during the Hyman litigation failed to make a serious impact on the quantity of new business that it received: because, as it seems to me, the Society retained those other features which made it an attractive investment vehicle". (7.53)

*Comments: - Chadwick does not mention that Equitable retained its image of propriety right up to closure to new business. But those that knew, left. The Personal Investment Authority (PIA) became aware in 1998 of the true facts about Equitable as has been known since the Baird Report<sup>49</sup> reported their investigations – see para 5.3 and 5.4 of that report. The PIA immediately moved their pension scheme away to another provider. (Apart from that self-interested move – about which questions were asked in the House of Commons eliciting no comment from either Ruth Kelly or Ms Hewitt)<sup>50</sup> "It appears, however, that IB-PIA never did contact Equitable Life in relation to any of the issues identified" – Baird para 5.9.5).*

- *Critically Chadwick does not appear to be aware of how Equitable sold itself. It was the only life company to publish a total bonus, and not only was that regarded as good transparent practice it was also the headline selling point which the other companies did not match. Furthermore during this period Equitable marketed its products based on the relatively favourable returns of policies accumulated over a previous long period (e.g. 20 years). Such policies had benefited from the good years of 1980s when the reserves were run down, and also the gross overbonusing of 1990 and 1994. Those who invested subsequently – particularly after 1994 - achieved relatively poor returns because Equitable was more cautious with its bonus declarations as it aimed to close the gap between the aggregate of policy values and asset value.*

<sup>47</sup> Chapter 6, para 28 of her main Report.

<sup>48</sup> See Table 4.1, Towers Watson Advice.

<sup>49</sup> 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, which Her Majesty's Government is submitting as evidence to the Inquiry conducted by Lord Penrose – 16 October 2001.

<sup>50</sup> *HC Deb 20 January 2003 vol 398 c46W 46W & HC Deb 28 January 2003 vol 398 c741W 741W.*

“In a letter to me dated 20 August 2009, the Ombudsman expressed her view as to the extent to which the maladministration which she had found would have affected the new premium income received by the Society. The relevant sentence of that letter was in these terms:-

*“In essence, the view expressed in my report is that, absent the serial maladministration I had determined from July 1991 onwards, no reasonable investor would have joined or remained with Equitable Life throughout that period – going instead to another life insurance company.” (7.42)*

While Chadwick had frequently disagreed with the Parliamentary Ombudsman, he went to town on this letter and a following one from her dated 17 October to disagree with her. He wrote a whole Annex of pedantry. For a start he picks her up for using “expressed in” as being equivalent to “in essence”, a scholastic point. He then analyses her statement that her findings covered the whole of the period from July 1991, claiming “as a matter of chronology, this is incorrect’ It is not the Parliamentary Ombudsman, but Chadwick who is incorrect – she started her second finding of maladministration from the date of publication of the regulatory return for 1990. And so he continues as he started in an unedifying and unnecessary exercise of hairsplitting legalistic triviality.

Having fabricated an ineffectively regulated Reconstructed Equitable, Chadwick concludes “that the differences in the level of bonuses and financial strength to which prudential regulation of the Society would have led if the maladministration accepted by the Government had not occurred would have given rise to some reduction in the new investment income received by the Society; but that that reduction would have been a relatively small reduction.” (7.52)

“Taking factors which I have identified and discussed into account, I am satisfied that there would have been some, but not a large, reduction in the extent of the new investment income which the Society would have received in the relevant period if the accepted maladministration had not occurred. In my view, the proportionate reduction would have been between one sixth and one quarter.” (7.76)

## 2. THE COUP DE GRÂCE

“On that basis [i.e. the modest reduction in premium income] I advise that, in the assessment of loss suffered by those who made new investments in the Society during the period between 1 September 1992 and 31 December 2000, the proportion to be applied to External Relative Loss should be 25% in the case of investment in WPA policies and 20% in the case of all other policies.” (7.77). This works out at 21% overall, or a discount of 79%. Applying this discount to Towers Watson’s ‘Stage 3 Loss’ (£2,300 - £3,000m) gives £475-£650m. But this is still too much for Chadwick. According to his perverse “logic”, ‘proper’ regulators not only would have made no difference to Equitable Life’s demise, they would actually have made outcome for policyholders worse. Towers Watson’s estimate of aggregate Internal Relative Loss, which is not disclosed in their letter to Mark Hoban, appears to be a negative figure of about £125-165m.

Chadwick's Internal Relative Loss is actually a PROFIT. Taking this into account, reduces Chadwick's final figure to £400-500m.

This was the coup de grâce – first cut values by 45% then by a further 79% and lo and behold Chadwick has got from the estimate of around £4½bh from the Parliamentary Ombudsman's concept down to £4–500m of his advice. Eliminate the Parliamentary Ombudsman's concept: think of a couple of meretricious concepts based on hair splitting sophistry and some biased multiplication – then bingo!