

APPENDIX???

20/06/98

GAD initiated a survey of the approach of life companies to reserving for guaranteed annuities.

26/06/98

Equitable applied for a section 68 order in respect of 1998 for a future profits implicit item of £850m.

c30/06/98

Equitable submitted their 1997 regulatory returns, which included a future profits implicit item of £371m by the due date. [GAD were scheduled to undertake the initial scrutiny and report the results to the Treasury by the end of August - see 31/08/98.]

29/07/98

Responding to GAD's survey of 20/06/98, Equitable said they had made no explicit provision for GARs in setting resilience or mathematical reserves; their investment policy took no account of the guarantees. Equitable's approach had not been modified by the debate within the actuarial profession on annuity guarantees. The cost of annuity guarantees had been more than adequately covered by the terminal bonus cushion to date for all but a few policies. Policyholders could pay additional premiums to which the guaranteed annuity rate would apply. As the business to which the guaranteed annuities applied aged, the increasing terminal bonus cushion made it increasingly unlikely that guarantees would actually bite [that is, require additional resourcing]. Not all policyholders were advised at retirement that there was a GAR option available to them.

31/07/98

GAD concluded their survey, which suggested that eight companies should be called in for discussions about their practices. Equitable and one other company were notable exceptions to industry practice in not holding substantial reserves to cover GARs, and Equitable seemed to be particularly vulnerable because the relevant business was approaching 30% of their total. (A different eight companies said they used the same differential terminal bonus approach as Equitable.)

08/98

From early August the media began to comment about the costs of guaranteed annuities to insurance companies.

13/08/98

GAD provided the Treasury's insurance division with a paper discussing the increasing value of GAR options resulting from lower interest rates and lighter mortality (average life-span had increased, with the result that people drew their pensions for longer). They said that companies now faced a significant problem with regard to GAR options, the scale of which GAD were investigating. GAR options existed in large numbers and threatened solvency in many cases and the actual, if not necessarily reasonable, expectation of policyholders in even more cases. There was a risk of them becoming the regulators' problem. The paper asked if varying the terminal bonus according to the cost of the GAR options met policyholders' reasonable expectations. GAD told the Treasury that, in their view, the terminal bonus could be restricted to keep down the cost of a GAR option, depending on the wording of individual policies. This would not however justify a lower reserve as the terminal bonus itself was not reserved for. To the extent that the GAR option applied to the full sum, the full pain had to be borne.

23/08/98

A newspaper article noted that some insurers might not be able to identify which policies contained a guarantee and, as policyholders might not have been aware of their entitlement, some may have received lower pension incomes than their due.

28/08/98

FSA's conduct of business division sent their media relations division and the Treasury's insurance division a memo referring to press comment on difficulties relating to GARs and saying that the matter was outside PIA's scope as the sales had occurred before the Financial Services Act 1986 had come into force. However, as the GAR issue also raised the question of solvency, the Treasury's insurance division were also investigating.

31/08/98

GAD's initial scrutiny report on Equitable's 1997 regulatory returns was due to be sent to the Treasury. [According to FSA, when it was subsequently decided to ask Equitable to submit their 1998 annual regulatory return early - see entry for 07/01/99 - it was decided to hold over the detailed scrutiny of the 1997 annual regulatory return and complete the review of that annual return alongside the detailed scrutiny of the 1998 annual return. That detailed scrutiny was completed in May 1999.]

09/98

GARs in many Equitable policies were by now some 30% above current annuity rates.

FSA's conduct of business division began to receive complaints about Equitable's treatment of GAR options.

01/09/98

GAD gave the Treasury's insurance division advice on company behaviour in relation to GAR options, including when a company should tell a policyholder if a GAR was valuable, which they said PIA should police. They said that the Treasury had a duty to ensure that policyholders' reasonable expectations were met along with other prudential matters. They suggested that the Treasury should circulate a note to all companies saying that avoiding GAR option obligations was unacceptable behaviour. All companies should be asked to report on the procedures in place to ensure that guarantees were included in quotations and the Treasury should use any complaints to trigger a visit to the company to review procedures. GAD concluded that a more proactive course, reviewing companies routinely, would be too resource intensive to be practical and would be open to criticism as a misuse of powers.

03/09/98

The Treasury's insurance division asked GAD for a meeting to discuss the issues raised.

The Treasury's insurance division sent a memorandum to FSA's relevant managing director whose remit included the regulation of insurance, and copied it to the conduct of business director. The Treasury noted recent media interest in GAR options and told the managing director about the GAD survey. They said that they would be considering the implications of the survey results for the fulfilment of policyholders' reasonable expectations. They said that the conduct of business division would have an interest in the extent to which companies were informing policyholders of the existence of GAR options when they came to make choices on retirement. This was an issue where both sets of regulators would need to work closely together to ensure a seamless regulatory approach.

08/09/98

Equitable received legal advice that their differential terminal bonus policy might be open to challenge. (This advice was not shared with the FSA.)

15/09/98

GAD told the Treasury's insurance division that it was reasonable to grant the section 68 order requested by Equitable on 26/06/98. They enclosed a copy of Equitable's reply to their survey dated 29/07/98 and commented that Equitable had a problem with GARs but saw no need to reserve for them as they reduced the terminal bonuses to balance out the additional costs. GAD recommended that the Treasury should explore the subject further by asking Equitable for relevant marketing literature in support of their approach in order to be satisfied that policyholders' reasonable expectations were being met.

17/09/98

Equitable reviewed with Counsel their GAR policy and options.

21/09/98

The Treasury's insurance division asked Equitable for relevant marketing literature or other evidence that their approach of reducing terminal bonuses met policyholders' reasonable expectations.

25/09/98

The Treasury granted Equitable's application (of 26/06/98) for a section 68 order for a future profits implicit item of up to £850m.

29/09/98

Equitable told the Treasury's insurance division that they adopted the unusual approach of guaranteeing full value benefits on retirement whenever it occurred. This was the fairer course for all. Equitable said that they recognised that guaranteed annuities could become valuable when interest rates were low. Their terminal bonus practice was intended to achieve equity between those taking benefits in cash or annuity form. The aim was to pass on 'smoothed earnings' achieved over the lifetime of the policy. (This was a way of ensuring that policyholders did not receive unduly high or low benefits as a result of fluctuations in equity values at the time the policy vested.) As terminal bonuses were allotted only at retirement they could vary and were not guaranteed. The presentation of results to clients concentrated on the vast majority who were interested in taking the cash option rather than an annuity. Equitable had first introduced the practice of paying a lower terminal bonus where a GAR option was exercised at the end of 1993; that practice had been disclosed in their returns to DTI each year since. All clients with policies containing GARs had had at least two annual statements describing Equitable's bonus philosophy.

01/10/98

Equitable sent the Treasury's insurance division a copy of a 1980s retirement annuity policy document containing GAR options and a copy of Article 65 from their Articles of Association, which gave directors discretion on awarding bonuses.

02/10/98

The Treasury's insurance division and GAD met Equitable to discuss Equitable's approach to deciding what benefits policyholders with GAR options received and the implications for solvency. The Treasury note of the meeting said that it had been agreed that Equitable would provide a revised assessment of the reserves required for GAR options. GAD and the Treasury would then consider the status of the future profits implicit items concession. Equitable said that their constitution gave them powers to vary terminal bonuses for different cohorts of policyholders. GAD, however, considered that the policy wording was open to interpretation. Equitable said Counsel had advised that they were acting fully within their rights. Equitable added that many of their policies to which GARs applied allowed payment of additional premiums, but that this was not a risk, owing to their treatment of asset shares; they accepted, however, that switches of policies into Equitable were a risk. GAD said that guarantees should be reserved for whether or not they were biting [that is, where the guaranteed rate was higher than the current annuity rate]. In their view Equitable should look at all their guarantees and options and make appropriate reserves. Equitable objected, saying that that could have severe consequences for them. They were concerned that in the then current climate tougher regulatory controls could tip companies into insolvency. However, Equitable agreed to assess the need to provide reserves for GAR options and to reassess solvency. The Treasury agreed that, if approached, Equitable could say that they "had responded to the GAD survey ... and they have been in communication with the Treasury with respect to that survey".

07/10/98

An Equitable policyholder wrote to the PIA Ombudsman complaining that Equitable intended to reduce the bonus payable under his policy if he chose to take an annuity at the guaranteed rate. The letter was copied to the Treasury's insurance division.

09/10/98

GAD told the Treasury's insurance division that companies needed guidance on their joint interpretation of policyholders' reasonable expectations for GAR options. It was GAD's view that policyholders with GAR options could reasonably expect to pay some premium or charge towards the cost, resulting in some reduction of the final bonus that would otherwise be payable. GAD said that they expected to see the cost met first out of any estate held within the fund, then by adjusting the future bonus allocations in the context of policyholders' reasonable expectations, which would be influenced by their policy documents and any representations made by the company.

19/10/98

At the request of the then Economic Secretary, the Treasury's insurance division briefed her on Equitable and their exposure to GARs. The Treasury said that they intended to issue guidance to the industry on handling GAR options in the context of policyholders' reasonable expectations. They explained that meeting the cost of GARs was putting a significant strain on Equitable's finances. As a mutual, Equitable did not have the option of a capital injection from shareholders. It was feasible that they would have to consider some form of de-mutualisation through merger, depending on how serious the financial situation proved to be. They had asked Equitable for more up-to-date information and the Treasury would monitor that and take any action necessary to protect policyholders' interests. Their initial view, on the evidence they had seen, was that Equitable's approach was consistent with the terms of the contracts sold and Equitable were endeavouring to fulfil the reasonable expectations of all their policyholders. They concluded that it was reasonable for policyholders to pay a charge towards the cost of the GAR option, provided this was allowed for in the terms of the contract. They proposed, subject to the then Economic Secretary's approval, shortly to prepare guidance on those lines for the industry. [The brief was not copied to FSA's conduct of business staff.]

The Treasury's Debt Management Office wrote to the Treasury's insurance division about the possibility of issuing a gilt, including an option designed to cover potential GAR option liabilities, if there were policy reasons making that desirable. They said that the suggestion had been put to them by a clearing bank. The Treasury's insurance division asked GAD for advice.

26/10/98

The Treasury's insurance division received oral legal advice from Treasury Advisory Division (Treasury's legal advisers) on the draft industry guidance.

The Treasury's insurance division sent the then Economic Secretary proposed guidance to the industry on methods the Treasury considered acceptable for meeting the costs of GAR options. These were that policyholders could be expected to pay some charge towards the cost of their guarantees, but that where the full cost could not be recovered from such charges, it might be appropriate to meet the costs from surpluses within policyholders' funds. The note added that Equitable's approach of reducing the terminal bonus had been criticised in the press but was in line with the proposed guidance. It was reasonable that with-profit policyholders, who stood to gain from the sale of contracts containing GARs, should share any associated losses. A response by 30/10/98 was requested. [The draft was copied to GAD but not to FSA's conduct of business division or PIA.]

30/10/98

Equitable told GAD that the GAR would provide a higher level of income in around 30% of retirement cases, but that so far no clients had chosen to take advantage of the GAR. [Note: Equitable's practice of reducing the terminal bonus for policyholders opting for the guaranteed rate would usually negate the benefit of the GAR.] Assuming the worst case scenario would require a reserve of £170m. However, they felt it prudent to reserve on the assumption that 30% of policyholders would exercise the GAR option, which would in itself represent a significant shift in policyholder behaviour. Equitable said that the commercial cost of the guaranteed annuities was highly unlikely to exceed £50m. To assume the most prudent approach (and reserve at £170m) would mean reserving at least three to four times the expected true commercial cost and, probably, a substantially higher multiple than that. Equitable felt that that would be inappropriate.

02/11/98

The Treasury's insurance division told their Debt Management Office that they were monitoring very closely exposure of companies to the GAR issue. They considered that the bank which had raised the question of a gilt (19/10/98) was somewhat overstating both the size of the problem and the difficulties posed for companies, but concluded that it was early days yet, and they would get back to them if their involvement was thought necessary.

03/11/98

GAD passed Equitable's letter of 30/10/98 to the Treasury's insurance division saying that it was not acceptable for Equitable to rely on the terminal bonus, for which they had made no provision, to meet the cost of the GARs. Equitable had not yet recognised that, nor had they attempted to quantify the reserves on the basis requested at the meeting held on 2/10/98. GAD said that the issue of adequate mathematical reserves was quite separate from that of applying GARs consistently with policyholders' reasonable expectations. Mathematical reserves needed to reflect the full value of the GARs; Equitable should reserve on that basis. That was necessary to comply with Regulation 64 of the Insurance Companies Regulations 1994. If Equitable were unable to meet that obligation, then intervention under section 37 or section 11 of the Insurance Companies Act 1982 might be warranted. GAD advised that the Treasury's insurance division should write to Equitable urgently inviting them to a meeting in the next few days to explain how they proposed to fund the mathematical reserves that were required.

c04/11/98

The Treasury's insurance division decided that an urgent meeting with Equitable was required to satisfy themselves that: Equitable were taking a proper view of their liabilities, not only the actuarial issues but also contractual rights; that Equitable had not cherry picked the policy and promotional documents provided so far; and to take a view on whether Equitable's approach was in line with the Insurance Companies Act requirements and more generally accorded with policyholders' reasonable expectations. They noted that it might be necessary for the Treasury to seek Counsel's opinion.

05/11/98

The Treasury's insurance division sent the FSA the draft guidance letter of 26/10/98 on how they expected companies to meet policyholders' reasonable expectations in dealing with GARs and the costs of meeting them. The Treasury drew attention to Equitable's "controversial policy" of paying the GAR on the guaranteed sum and not on the terminal bonus. They said that their preliminary view was that Equitable were entitled to do this, but they were seeking further information to test the position further. Their primary concern, however, was over Equitable's ability to reserve adequately for these guarantees. They commented: "The information received to date is unconvincing and raises serious questions about the company's [regulatory] solvency." The Treasury said that they were meeting Equitable again the following week to discuss what further steps they might require Equitable to take.

A copy of this note was sent to the FSA's conduct of business director who endorsed it on to a senior colleague saying "Are we clear that PIA has no standing in this, because the business was written pre the coming into force of the '86 Act?" The recipient passed the note to another colleague saying that was also his understanding of the position.

The Treasury's insurance division wrote to Equitable noting a wide discrepancy between their views on Equitable's approach to reserving for GARs. They said that in accordance with Regulation 64 appropriate mathematical reserves had to be established for the full value of the GARs. Equitable had not even attempted, as requested on 02/10/98, to quantify the reserves on that basis. An urgent meeting, to be held at the Treasury, was required. After that discussion, the Treasury would write again setting out more fully what further steps they might require Equitable to take. The meeting would also offer an opportunity to discuss further the issue of policyholders' reasonable expectations arising from Equitable's treatment of GARs.

06/11/98

FSA's chairman wrote to the director of the Treasury's insurance division to ask for advice about questions which had been put to him about GARs, and Equitable's approach. These included whether Equitable were right in their view that they could fund a guarantee by reducing bonuses or whether that was inappropriate and the regulators should outlaw it; whether there had been a failure of prudential supervision if the with-profits fund could not bear the cost of these guarantees; and what would happen if the funds were not available to pay up except by reducing the size of the fund below a level which actuaries felt was required to deal with other policyholders' reasonable expectations. Would not regulators then be invited to "pay Peter by robbing Paul", and how would the decision be made?

A copy of the memo went to the conduct of business division where a manuscript note was made on it, which said that the division did not think these were matters for them.

09/11/98

FSA's managing director told the Treasury's insurance division that in his view it was "critical" that they sought further information to test their preliminary view of 05/11/98, that Equitable were entitled to pay the GAR only on the guaranteed sum and not the terminal bonus.

11/11/98

Equitable apologised to the Treasury's insurance division for misinterpreting their request for additional information. They said that the basic additional reserve at 31/12/97, on the basis requested, would have been c£675m; projected to 31/12/98 at a valuation interest rate of 5% the basic additional reserve would have risen to £1,375m. However, it was difficult to assess the impact of future premiums [i.e. of top-up payments] as it would mean scanning the files at the year-end to determine where entitlement to pay further premiums existed (contractually entitlement was lost if a premium was not paid each year). The Treasury's insurance division asked GAD to suggest what information they might ask Equitable to provide to satisfy themselves of the reasonableness of Equitable's actions in terms of policyholders' reasonable expectations.

12/11/98

An internal minute within FSA's conduct of business division commented on the chairman's note of 06/11/98 to the director of the Treasury's insurance division. They said that there were marketing as well as prudential aspects to the issue. PIA had not formed a view on the Equitable case. However experience of with-profit cases had shown that it was difficult to prove a complaint that would restrict a firm's flexibility in the way it declared bonuses. The author had not seen the wording of Equitable's policies which would clearly be significant. Nevertheless, while Equitable might properly be able to reduce bonuses, they were acting in poor faith in doing so.

GAD briefed the Treasury's insurance division to ask Equitable for any material supporting the adoption by Equitable's board of a two-tier terminal bonus system as a modification of policyholders' previous expectations.

13/11/98

The Treasury's insurance division, their legal advisers and GAD met Equitable to discuss GAR options and the implications for policyholders' reasonable expectations of Equitable's treatment of policyholders with such options. The Treasury's insurance division said that Equitable's policy of reducing terminal bonuses for policyholders with GAR options that were biting was a high profile industry issue. Equitable said that Counsel had endorsed their position and concluded that their directors had not used their powers improperly. They agreed to provide the Treasury with a copy of Counsel's opinion and supporting materials. The Treasury's insurance division said that projections to policyholders with GAR options had apparently shown the GAR applied to the unadjusted terminal bonus; Equitable said that even if that were the case, the level of terminal bonus had not been guaranteed. The Treasury's insurance division asked for information to allow them properly to understand what impression had been given to policyholders over the years. Equitable said that their sales force covered the GAR option in their dialogue with policyholders only if it was more attractive to the policyholder. The Treasury asked for a list of policy numbers that had matured in the last three years. They would then select a sample of maturing policies at random and examine them. They again told Equitable that they should reserve for what was payable under the contract, arguing it was a statutory requirement and they expected Equitable to reserve on that basis [their emphasis]. Equitable said that the timing of any additional reserving was a critical issue. There would be severe commercial implications from reporting low solvency cover, but they were convinced the company would remain solvent. Equitable said that they were considering applying for a section 68 order with respect to the resilience calculation which would assume only 50% of policyholders took the GAR option. They agreed that they would need to think about reducing bonus declarations, but said it was impractical to think that they could slash them harshly without serious implications for public relations. (FSA's conduct of business division were not represented at the meeting.)

[According to the Baird report, Equitable's exposure to top-ups (whereby some policyholders were entitled to pay additional premiums at any time and any GARs applicable to the policy in question would attach equally to those additional payments, and which were referred to in Equitable's response to the GAD survey - see entry for 20/7/98) was also considered at this meeting, but I have seen no evidence of this.]

16/11/98

GAD told the Treasury's insurance division that, if differential terminal bonuses were permissible under the policy wording, then they seemed to be legally acceptable. Equitable might be open to policyholder complaints, but GAD did not believe that the Treasury could raise objections. Equitable had told GAD about the possibility of their applying this practice in their 1993 regulatory returns, but had first told policyholders in a bonus notice issued in January 1996. Equitable were reluctant to grant to GAR policyholders bonuses materially in excess of their asset shares, to the detriment of other policyholders. However there was still the question of whether their practice was consistent with policyholder expectations. GAD expected that early marketing

literature would not have covered the possibility and Equitable were relying on their general discretion and accordingly remained open to legal challenge. GAD remained convinced that full reserves for guaranteed annuities should be carried.

The Treasury's insurance division wrote to Equitable asking for copies of literature given to policyholders and of Counsel's opinion. They also expressed concern that where the GAR option was biting to the extent that there would be no terminal bonus if the GAR option was exercised, the policyholder would receive lower benefits if choosing the cash option. The specimen contract provided prior to the 02/10/98 meeting could be interpreted as entitling the policyholder to cash to the same value as the GAR option in such cases. They repeated that Equitable were obliged to reserve on the basis that the GAR options would be exercised in 100% of cases, if more valuable than current annuity rates. The Treasury's insurance division said that they recognised that that could have a significant impact on Equitable's financial position. They asked for the latest estimates of free assets and solvency cover and for the latest management accounts. [The letter was copied to GAD but not to FSA's conduct of business division.]

18/11/98

Equitable sent a holding reply to the Treasury's insurance division, adding that surplus assets and implicit items before reserving for GAR options were around £2bn.

19/11/98

The then Economic Secretary, who was not content with the proposed guidance sent to her on 26/10/98, commented that if people had bought a contract it was a guarantee and they should not subsequently be expected to pay for the guarantee themselves. She questioned whether shareholders should bear some or all of the costs involved, also whether use could be made of free estate where it existed. [Neither point was in fact relevant in Equitable's case because they had no shareholders and no free estate to speak of due to their policy of full distribution to their policyholders.]

23/11/98

Equitable sent the Treasury's insurance division a full reply to their letter of 16/11/98 including: policyholder literature, illustrations of when the GAR option would and would not produce higher retirement income, and a copy of Counsel's opinion. Counsel gave the opinion that Equitable were "justified in law" in adopting the approach of declaring differential final bonuses in order to ensure (so far as was possible having regard to the operation of guaranteed annuities on previously guaranteed values) that the ultimate cash value of any given policy would be a single sum, irrespective of whether the policyholder took the guaranteed benefits under his policy or elected to take an alternative annuity based on application of the current annuity rate. Counsel added that the top-up element would be allocated by the Board exercising its discretion under article 65 (see 01/10/98), which was wide enough to enable bonuses to be allocated among members in top-up form as well as in annual and terminal form. The Treasury's insurance division circulated Counsel's opinion to their legal advisers and to GAD for comment.

24/11/98

Equitable wrote to GAD, who copied the letter to the Treasury's insurance division and legal advisers. It was Equitable's view that since 1993 GAD had tacitly accepted their approach to reserving. [See also the entry for 04/01/99 below.] They could not see why, in the face of logic and practical experience, prudence necessitated assuming that 100% of benefits would be taken in the most onerous form. Equitable's auditors were said to support their position. Surplus assets at 30 October 1998 were £1,164m and they had a section 68 order allowing implicit items of up to £850m to be brought into account. Equitable argued against GAD's position, saying that the choices available, if onerous reserving were to be required, included declaring no bonus. If Equitable gave way to pressure to adopt an excessively prudent and over-cautious reserving basis, the consequences for the company were potentially extremely serious. Equitable said they would need to consider what steps to take in terms of consulting with the [actuarial] profession; informal soundings indicated they were not alone in their interpretation of Regulation 64. Guidance note DAA10, from the Government Actuary, amended the guidelines for resilience test 2. The note said that, while the revised test was necessarily more complex, it was intended to avoid the unreasonable stringency which might apply if equity markets fell below their current levels. However, if applied to other types of business, it was not appropriate to include in the test any element which, taken overall, served to reduce the prudential effect of the test.

GAD provided the Treasury's insurance division with a note intended to assist them in explaining their position more fully to the then Economic Secretary. They noted the difficulty for insurers such as Equitable, for whom the residual cost of the guarantee was relatively high, with no shareholders or free estate and where the guarantees fell to be met by either the beneficiaries or the remaining policyholders.

A manuscript note by the Treasury's insurance division said that it was important to be clear that there was no one right answer and that different solutions were possible, each of them fair.

25/11/98

GAD sent the Treasury's insurance division in confidence a report of the results of their survey which they had prepared in September. They pointed out, however, that the situation had moved on, as they were in the process of interviewing the worst affected companies and so the detailed information was now out of date. They said the quality of the survey responses had not been sufficiently rigorous for them to draw conclusions about the 74 individual companies and that the report should therefore be interpreted as giving only a general overview. The survey suggested that while most guarantee schemes were "in the money", some were not. Applying a minimum reserving standard of a prudent mortality rate, 4.5% interest and 2% for expenses, they believed that the industry would need to establish additional reserves of some £10bn, which did not include any allowance for costs arising from the receipt of future premiums under contracts with GAR options. Equitable seemed to be particularly vulnerable. Across all companies at the end of 1997 there may have been an unrecognised liability of some £3bn, around half of which related to Equitable, who could be technically insolvent [regulatory insolvency was intended]. The issue of annuity guarantees would be raised with each company as part of the scrutiny process for their regulatory returns. GAD stressed, however, that their methodology was open to question, as an annuity basis suitable to the whole population was likely to be unsuitable for a given product line. Most insurers writing with-profits business were considering carefully whether to reduce the final bonus to policyholders with GAR options; the practice was being followed by eight companies, including Equitable. Seven companies, including Equitable, did not inform policyholders about the existence of GAR options.

26/11/98

An updating note prepared by the Treasury's insurance division about the effect of current market conditions on life insurers noted that Equitable were one of four companies facing serious difficulties. Equitable were just covering the required minimum margin if all policyholders exercised their GAR options. Publication of such a low solvency position was likely severely to undermine their reputation and could threaten their survival as an independent entity. Discussions were continuing about the reserving basis to be used and Equitable's approach to charging policyholders for the cost of GAR options.

01/12/98

GAD reviewed the legal advice Equitable had sent on 23/11/98 and told the Treasury's insurance division that in their view the advice did not wholeheartedly support the actions Equitable had taken thus far. As they saw it the documentation to date had not adequately described the bonus methodology Equitable were adopting. Counsel had said, and GAD agreed, that the policy wording required Equitable to allocate the terminal bonus before the policyholder decided which benefit to take. However the legal advice to Equitable was that a differential terminal bonus could be applied under [article 65] requiring Equitable to declare a lower terminal bonus to GAR policyholders, with a bonus for those not taking the GAR option. It was possible that past policyholders whose policies had matured could successfully argue they had not been treated fairly. The Treasury's insurance division had also noted a risk that Equitable could be liable to pay the guarantee on top of the full fund, with a need for an appropriate provision. (An officer of FSA's prudential division commented in manuscript "i.e. need to reserve on basis that Eq Life might lose in Court.")

GAD wrote to the Treasury's insurance division about reserving saying that, under Regulation 64, policy valuation had to take account of all prospective liabilities, including guaranteed annuities. Equitable needed to have sufficient assets now to cover the final bonus that might be payable in lieu of the GAR option benefits. If Equitable reserved in full for 100% of benefits in GAR form, they would just have sufficient cover for their required margin of solvency as at 30/10/98. While this might not suit them commercially, it indicated that they were very reliant on future surpluses to fund future bonuses, including terminal bonuses. It was difficult to see how Equitable could justify declaring any bonus at the year-end. In the medium term they would need to look for some ongoing form of capital support if they were to remain viable under difficult investment and trading conditions.

02/12/98

The Treasury's legal advisers gave their insurance division interim advice on Counsel's opinion provided by Equitable on 23/11/98. They said that they found it hard to take issue with the opinion, although they noted that that had been given in the context of contract and trust law. They said that they understood the insurance division to be of the view that consideration of policyholders' reasonable expectations might go beyond that; were that to be the case, the opinion would not be an end to the matter. They said that the insurance division would want to reach their own view on policyholders' reasonable expectations. On the question of reserving, Regulation 64 was very wide and it was for the courts, not the Treasury, to decide if liabilities had been properly determined. There was room for more than one reasonable view of proper provision and prudent assumptions, though any entity adopting the Treasury's and GAD's view on reserving would be within Regulation 64. It was not clear, however, whether Equitable's view was in breach of Regulation 64; it would probably be for the Treasury to show a breach, not for Equitable to show compliance. If Equitable were not in breach, then the legal advisers were not clear on what basis the Treasury might take action against Equitable.

FSA's conduct of business division circulated a note to their managers on recent press articles about Equitable and other firms who had offered GAR options. They said that this might become a big issue affecting a large number of firms and costs of billions of pounds. There was speculation that mutuals might find it hard to survive if they had to honour GARs. FSA's conduct of business division commented on the difference in approach between prudential regulation, focusing on a firm's ability to stay in business, and conduct of business regulation, looking at what the firm had promised investors and whether they should be liable to pay the maximum figures. They said that they had been in touch with the Treasury's insurance division who were looking at the position, particularly with regard to Equitable's regulatory solvency, if the guarantees were enforceable. The insurance division were also reviewing Equitable's literature (policies and bonus notices) to enable them to take a view about what reasonable expectations a policyholder might have had from reading it.

03/12/98

The Treasury's insurance division and GAD met Equitable and told them that, in their view, there was at least a possibility that dissident policyholders seeking a GAR option on an unadjusted terminal bonus might win a case in court. Equitable admitted that that was at least a potential contingent liability. GAD denied Equitable's assertions that for several years they had tacitly accepted Equitable's approach. They said that they were aware from their regulatory returns that Equitable had written GAR option business, but not the construction of the contracts or the reserving basis. The Treasury said that they saw no scope for concessions on reserving. Equitable expressed concern that they were being forced to adopt a "wildly prudent" reserving approach, bearing no resemblance to commercial reality, and damaging to policyholders. On being told that there was no appeal other than by way of judicial review, Equitable said that they might well have to take up that option. They did not expect the policyholders' action group to bring legal action in the near future. Equitable said that they had considered reinsurance as an option to protect the balance sheet, but were reluctant to broadcast their position to potential reinsurers while they were still hoping the regulatory position might change. Even if reinsurance was purchased it was unlikely to be in place that year. The Treasury said they thought it would be possible to give a post-dated concession to cover the 1998 year end. However, they still had some way to go before coming to a conclusion about the reasonable expectations of Equitable's asset share treatment for policyholders with biting GAR options. The Treasury were concerned about whether policyholders' reasonable expectations had been met for policies that had already matured, and they gave Equitable details of the further material that they wished to see in relation to this.

04/12/98

The Treasury's legal advisers gave their insurance division further interim legal advice on the reserving issue. They said that, on balance, a court was likely to accept that Equitable's position was untenable, though they were not convinced that a court would accept that Regulation 64 required reserves to be made on the assumption of 100% take-up of GAR options. A court would be likely, however, to accept that 100% or thereabouts was required in this case if Equitable continued to maintain their position that a much lower rate could reasonably be assumed. Action to be taken if Equitable "did not come quietly" [which I presume meant if Equitable did not accept GAD's view on reserving levels for GARs] could include pursuing them for breach of section 45 (see paragraph 34) on the grounds that the criteria of sound and prudent management were not being met. Such intervention was

unlikely to be successfully challenged in the courts. However, the onus rested on the Treasury to show that Equitable had breached the regulatory requirement. The legal advisers said that they still found it hard to take issue with Equitable's Counsel's advice in respect of the differential terminal bonus practice, although they reiterated their comments regarding the context in which that advice had been given [see 02/12/98].

07/12/98

The Treasury's insurance division sent Equitable a note of the main points of the 03/12/98 meeting. It said that Regulation 64 pointed to assuming that 100% of policyholders took their benefits in GAR form. To the extent that Regulation 64 could be disapplied by a section 68 order, the Treasury would not be inclined to make such an order. They rebutted the arguments on reserving advanced by Equitable and said that they did not accept that an assumed GAR option take-up rate of 35% was prudent, nor that a reserve based on the cash option should exclude a terminal bonus. Treasury's insurance division agreed to consider the possibility of any reinsurance arrangement as having been effective from the year end, provided that at least the broad terms of the agreement were in place by that date and a firm intention to enter into the agreement could be shown. They added that, if Counsel's advice was followed, there was little doubt that policyholders' reasonable expectations would be met in future, but they questioned whether they had been met in those cases where policies had already matured. They concluded that they expected to see in Equitable's regulatory returns an appropriate statement on contingent liabilities, related to the risk of successful challenge to Equitable's bonus practice for GARs.

08/12/98

GAD told the Treasury's insurance division that an alternative valuation basis for GAR contracts could satisfy Regulation 64. It could be reasonable to assume that less than 100% of policyholders would elect to take the GAR, provided that the reserve held in respect of those assumed to take an alternative form of benefit was based on a realistic value of that alternative. They suggested a formula for calculating this and said that while it might be prudent in Equitable's case to assume that only 50% of policyholders were to choose the GAR option, the value of the alternative option should be not less than 95% of the liability arising if the guaranteed benefit were selected. GAD said that they had no objection to Equitable being permitted to phase in the new formula over a reasonably short period of time, subject to their providing assurance that the phasing in would be completed before significant liabilities began to arise. They also recommended that the Treasury's insurance division seek some commitment from Equitable to reduce the declared reversionary bonus until full provision for the GAR liabilities had been made. GAD added that Equitable's reply to the survey of 29/07/98 had disclosed their significant exposure to GAR options. GAD offered to discuss Equitable's approach with the appointed actuary.

In an internal note (not copied to the prudential division) FSA's conduct of business division commented that the relevant annuities had all been sold before the Financial Services Act 1986 came into force and so were probably not caught by PIA rules. However, if Equitable should have provided for paying the GAR and full terminal bonus but had not, and had therefore been able to offer

investors returns in recent years more generous than they would otherwise have been able to, then that now enabled them effectively to inflate past performance figures. FSA's conduct of business division decided, before taking any action, to await the outcome of the Treasury's insurance division's review of how Equitable were interpreting their obligations against the test of policyholders' reasonable expectations. Any action would need to be taken working closely with the Treasury's insurance division.

09/12/98

The Treasury's insurance division gave the then Economic Secretary more background to the proposed further guidance letter on policyholders' reasonable expectations, including a fuller justification for the lower final bonus, and again sought approval. They said that the particular difficulty for Equitable was that guarantees had either to be met by the benefiting policyholders, or spread across all with-profit policyholders who shared in the overall profits and losses of the relevant business. As Equitable had approximately 25% of its with-profits business affected by GARs, and the level of guarantee was high, the impact on the total amount of bonuses payable was relatively large. Equitable were charging the residual costs of the GAR options to the beneficiaries by reduced final bonus. Contractually it was arguable whether they were obliged to spread the cost more evenly across all policyholders and the Treasury were seeking more information about that. There would be no failure of policyholders' reasonable expectations where an insurer had an asset share policy that had been clearly communicated.

10/12/98

Equitable told the Treasury's insurance division that they did not accept the Treasury's view of what constituted a prudent reserve; in the light of favourable legal advice they had received, they were willing to challenge any use of FSA powers through judicial review. Equitable said that they were also pursuing the possibility of reinsurance and wished to meet with the Treasury's insurance division again shortly.

The head of the prudential division said, in a personal file note, that Equitable must reserve on the basis of the contract and must cover all guaranteed annuities. The consequences for Equitable were serious but needed to be faced now. Referring to policyholders' reasonable expectations, he said that it was at least arguable that they should pay guaranteed annuities on the 'full' final sum as the literature implied this. There was a risk of needing to reserve for higher payments for 1994-98, and a need to make an appropriate reference to contingent liability in the regulatory returns. At 25% above current rates, Equitable [GAR] policyholders would find cash commutation attractive across a wider range of economic conditions than other companies.

11/12/98

The Treasury's legal advisers told their insurance division that there was no provision to require a company to reissue or amend accounts when it had breached Regulation 64. They expressed the belief that a court would expect the Treasury's insurance division to prosecute a clear breach of the Insurance Companies (Accounts and Statements) Regulations 1996 [which prescribe the form and content of the annual returns that companies are required to submit] or to act under section 45 of the Insurance Companies Act (paragraph 34) if they considered Regulation 64 insufficient in a particular case. They said that a decision to intervene to direct that past published accounts should be corrected would have to be supported by good grounds.

c15/12/98

In preparation for handing over prudential regulation to FSA, the Treasury's insurance division briefed FSA's chairman and the managing director on their current views on Equitable's position. Equitable proposed to reserve for 25% of GAR options which meant free assets of £2,452m; the Treasury said that, if Equitable reserved for 100% of GAR options, their free assets would then

only be £220m and insufficient to declare a bonus, the cost of which, assuming they maintained the current level, would be £500m. The Treasury's view was that they must reserve at or close to 100% for GAR options. This was because Equitable were effectively having to guarantee to pay terminal bonuses to GAR option policyholders at a level which made the cash option worth as much as the GAR option; accordingly they should reserve for what was effectively a guaranteed benefit. The Treasury said that they were not minded to act for failure to reserve fully for GAR options in the 1997 returns (which would be consistent with the approach taken with other companies) but Equitable would be formally told that FSA would intervene if the 1998 returns did not comply. Intervention, which would be likely to be in terms of closing the company to new business, would follow if Equitable either declared a further bonus without prior discussion with the Treasury, or declared a bonus that would breach its required minimum margin if GAR options were fully reserved. They concluded that Equitable could be expected to seek judicial review of any intervention action in relation to reserving for GAR options.

15/12/98

The Treasury's insurance division and FSA's chairman and relevant managing director met for a briefing on issues relating to Equitable, including the draft guidance on the reserving standards required. FSA queried the nature of the future profits that could be taken into account to cover a company's solvency margin. The Treasury explained that only future profits on business already written, and only a conservative estimate of that, was allowed in the returns. As to the fact that no action had been taken against Equitable in respect of their 1997 returns, FSA's managing director said that he considered it defensible for the Treasury to change their view as the picture filled out and

The significance of GARs changed. It was considered that Equitable's Counsel's opinion provided reasonable comfort that their approach of reducing terminal bonuses to meet the cost of the GAR was consistent with policyholders' reasonable expectations. The Treasury went on to say that, assuming 100% reserving for GAR options was necessary, Equitable should not be permitted to make itself insolvent [in a regulatory sense] by declaring further bonuses - but they also acknowledged that not to declare a bonus would be very damaging commercially; the chairman was reported to have said that for Equitable to be forced to pass a bonus would amount to commercial suicide. The Treasury added that they had had discussions with several other companies which had accepted that GAR options had to be fully reserved.

FSA's chairman was concerned that the Treasury's approach should be defensible in view of the risk of judicial review; the proposed guidance letter (on reserving policy) would be helpful. FSA's managing director expressed concern that any relaxation in the Treasury's position on reserving levels for GAR options would undermine their position, as any level below 100% was necessarily arbitrary. He was also concerned that the Treasury did not appear to have solid support for their position from GAD. The Treasury said that GAD were considering a relaxation of the reserving requirement to 97.5%. It was suggested that Equitable, or another company acting in response to guidance that the Treasury proposed to issue on the required level of reserving, might seek judicial review of their position. It was felt however that, even if that were to happen, it would not block any action that the Treasury might wish to take against Equitable in the meantime. A move by the Treasury to prevent Equitable declaring a bonus could be justified as action to prevent a breach of the criteria of sound and prudent management, and so should be outside the immediate scope of any judicial review. FSA's chairman said that Equitable might prefer seeking a buyer to judicial review. It was agreed that a takeover would not be a good result for the company or for the Treasury. The chairman considered it important to understand the sensitivity of the financial positions of Equitable and others to movements in gilt yields; the Treasury said that they would assess this further. It was noted that Equitable had reported little contact with the policyholders' action group and had received few complaints. The Treasury told FSA that, importantly, the financial position would not be made worse (assuming it had already reserved at 100%) if Equitable had to abandon the approach of reducing the terminal bonus paid to policyholders exercising the GAR option. The only additional cost would be topping up payouts that had already been made to policyholders. FSA agreed that the Treasury appeared to be taking the only sensible approach.

GAD told the Treasury's legal advisers and the Treasury's insurance division that they did not agree there were no grounds to require a company to amend or reissue accounts that breached Regulation 64 and pointed to sections in the 1982 Act which they believed did give the Treasury that power.

Following the fuller justification of 09/12/98, the then Economic Secretary agreed the draft guidance letter to insurers first proposed by GAD on 09/10/98.

16/12/98

In reply to a complaint from a policyholder about Equitable's differential terminal bonus policy, the Treasury's insurance division said that guaranteed benefits did not normally extend to discretionary final bonuses. A number of insurers therefore considered that the level of discretionary bonus might be adjusted to ensure fairness between policyholders. Such an adjustment was particularly relevant for mutual insurers, who would find it difficult to provide additional amounts of discretionary bonus beyond the value of the accumulated premiums attributable to the policyholders in question, without prejudicing the interests of other policyholders. The Treasury believed that they were treating all mutual insurers in a similar manner.

Equitable's Board resolved to initiate a test case in the courts to determine whether they had the right to declare differential terminal bonuses.

17/12/98

The Treasury's insurance division sent the draft guidance (on the principles which life insurers should follow in determining how to handle GAR options in the context of policyholders' reasonable expectations) to FSA's managing director. They said that, while the letter set out general principles, which were intended to ensure a consistent and fair approach overall, some commentators were likely to see it as relating primarily to Equitable.

Equitable sent the Treasury's insurance division some of the documentation requested at the meeting on 03/12/98.

18/12/98

The Treasury's insurance division issued to life companies their guidance letter (DD1998/5) on policyholders' reasonable expectations. They said that policyholders with GAR options could expect to pay some premium towards the cost of those options. They considered that, generally, it would be appropriate for the level of charge to reflect the perceived value of the guarantee over the duration of the contract. That could be achieved in some cases by a reduction in the terminal bonus added at maturity, though the approach to be taken by each company would depend on the wording of the contract involved and how it had been presented to policyholders. They said that each company would have to assess the appropriateness of such adjustments

to bonus allocations in the context of the reasonable expectations of all policyholders; that assessment would be influenced by the policy documents and any representation made through marketing literature, bonus statements or elsewhere. The guidance was given without prejudice to any decision of the courts.

Equitable sent the Treasury's insurance division joint leading Counsels' opinion, which said that the Treasury's requirement for reserving was manifestly unfair and open to judicial review as in breach of Equitable's legitimate expectations, and also ran contrary to policyholders' reasonable expectations as it would lead to a reduction in future bonus payments. Equitable said that they had decided, on leading Counsel's advice, to initiate a test case in the High Court to confirm that their directors had acted properly and within their powers on their practice on terminal bonuses. (A Treasury officer's manuscript marginal notes commented that they had not been aware that GARs had exceeded current annuity rates to any significant extent from 1994 onwards, and that they had acted as soon as they had become aware of the situation.)

GAD told the Treasury's insurance division that at the meeting on 28/05/98 they had urged Equitable to exercise great restraint in granting guaranteed bonuses. GAD did not accept that it would necessarily be commercial suicide for Equitable to grant no additional guaranteed bonuses that year on contracts containing GAR options, so long as the reasons were properly explained. Indeed, this was probably necessary for prudent management.

The Treasury service level agreement with FSA was signed. The Treasury contracted out to FSA responsibility for most aspects of prudential regulation (certain matters, such as the issue of section 68 orders could not be contracted out and were reserved to the Treasury).

Late 12/98

The Treasury's insurance division received the remainder of the materials requested from Equitable on 03/12/98.

22/12/98

The Treasury's insurance division and GAD met Equitable to discuss the legal opinion of 18/12/98. The Treasury agreed to provide a formal response to the legal opinion as soon as possible. They commented that it was for Equitable to reserve as they saw fit, but that the Treasury would take regulatory action if reserves were inappropriate or if Equitable's actions imperilled solvency margin cover. They would act, for example, if bonus declarations were imprudent. Equitable agreed to liaise with the Treasury prior to deciding a bonus strategy, but did not guarantee not to pay further bonuses to policyholders with GAR options. They said that, although they were looking to reduce bonuses generally, it would be difficult not to give policyholders with GARs some bonus. Equitable repeated that they did not agree that the reserve should be 100% and that the regulatory regime did not require reserving for terminal bonuses, this was something the Treasury were suddenly applying.

The Treasury said that the terminal bonus was effectively guaranteed up to the value of the guaranteed annuity since if no terminal bonus was added, everyone would take the guaranteed annuity. For their part, GAD again [see 03/12/98] denied that they had tacitly accepted Equitable's past reserving practice for GAR options. They pointed out that the information disclosed in the return was limited and gave them no reason to question the validity of the reserving basis. They said that the actuarial working party had concluded that holding no reserve and assuming the cost of GAR options could be met from terminal bonus was imprudent. The Treasury said that 100% reserving was being required industry wide.

Equitable said that they accepted the need to put up a substantial reserve but still considered the level the Treasury required to be excessive. They said that reserving for the full amount of the guarantees would seriously constrain investment strategy, and low solvency would threaten the company's future. These combined could put immense pressure on them to find a buyer. They added that there were further margins in the reserving that could be released, giving them further free assets of approximately £200m; they could also apply for a section 68 order for a larger future profits implicit item up to £1.9bn. The Treasury acknowledged that they were likely to treat such an application sympathetically. Equitable suggested that the blow could be softened by assuming that 30% of all relevant policyholders would take the guaranteed annuity, while reserving at 100% in respect of those policyholders closest to retirement. The Treasury said that they were sympathetic to that aim, as they understood the potential for policyholders to be adversely affected by a "sudden hit" of such magnitude and they agreed to consider any such proposal as an interim measure. Equitable concluded that they were actively discussing reinsuring the reserves for GARs.

Equitable applied for a revised [see 26/06/98] section 68 order for a future profits implicit item of £1.9bn, to be counted towards their solvency margin on 31 December 1998.

23/12/98

GAD told the Treasury's insurance division that they supported the application for a section 68 order.

31/12/98

The Treasury's legal advisers reaffirmed to GAD their view that there was no power as such to require reissue or amendment of accounts which breached Regulation 64. They also gave their insurance division a draft response to the legal opinion provided by Equitable on 18/12/98.

Equitable asked the Treasury's insurance division for a response to the legal opinion as promised at the 22/12/98 meeting. Equitable said that they had received an offer in respect of a financial reinsurance arrangement from a reinsurer. Further information would be provided shortly after 07/01/99 "should we wish to proceed". Attachments sent with the letter included a copy of a fax dated 23/12/98 from the reinsurer saying that they were most interested in finalising a contract that would meet the needs of Equitable in respect of the issues discussed; it was hoped to resolve these to enable a contract to be drawn up to reflect the concept discussed. A manuscript endorsement by the Equitable recipient said: "... this, apparently is the letter of intent, and we shall not be receiving anything else in writing before our meeting on 7 January". The costs would be: an annual premium of £50,000; in the event of a claim, 2% of the claim; repayment of any claim over about three years from earnings in excess of those required for the statutory valuation.

The Treasury granted Equitable's request for the section 68 order.

Equitable had over £28bn of investment funds under management, which included over £21bn in their with-profits business. The statutory reserves required for GARs were £1.6bn.

1999

01/01/99

The Treasury's insurance division transferred to FSA and operated subsequently as part of the Insurance and Friendly Societies Division [to whom I shall refer as FSA's prudential division]. Their legal advisers transferred to FSA's General Counsel's Division.

04/01/99

GAD told FSA's prudential division that they were reviewing Equitable's mathematical reserves and that three actions were required: first, to tell Equitable they were not satisfied with zero mathematical reserves (paragraph 28) for the GARs in the 1997 returns; secondly, to provide Equitable with a response to Counsel's opinion; and thirdly, to obtain additional information from Equitable about mathematical reserves, resilience, and asset shares, and also the most recent financial condition report produced in accordance with the Faculty and Institute of Actuaries' guidance note. GAD also commented that Counsel had overlooked the key point that prudent assumptions about the proportions of policyholders who might exercise each option ought to depend on the relative values of the benefits, which had increased considerably in the recent past as interest rates fell. Recent take-up rates were irrelevant as additional discretionary cash sums had been paid to those choosing the cash option rather than the GAR, but Equitable did not propose to make provision for future additional cash bonuses. GAD accepted, with hindsight, that they might have questioned rather earlier Equitable's treatment of GARs in the context of the 1993-1996 regulatory returns; however, Equitable had not sought to discuss the question of reserving with GAD or with the Treasury's insurance division, even when it had become a material issue. GAD said that they had not accepted the reserving basis used in the 1997 regulatory returns, and had not had any direct communication with Equitable about them. They agreed that if Equitable were to establish a £1.5bn reserve, it would affect future bonuses, and said that they would consider the question of phasing in the higher reserving requirement in the light of the additional information now being sought.

FSA's legal division told their prudential division that Counsel's opinion provided by Equitable did not cause them to change their view set out in their letter of 07/12/98, and did not even seek to address the regulator's position on the issues. Policyholders could be expected to select the cash commutation only while its value was maintained at close to the value of an annuity taken at the GAR rate. GARs should, therefore, as a matter of prudence be fully reserved. The GAR problem had been revealed only when the Treasury had begun to consider the responses to the GAD survey.

07/01/99

FSA's prudential division briefed their chairman recommending further draft general industry guidance on reserving for GARs and that FSA's prudential division should require companies whose 1997 regulatory returns did not comply with the new guidance to submit their 1998 returns early. They proposed writing separately to Equitable and attached a draft letter. They said that Equitable had a legitimate expectation that they had until the end of June to present their 1998 return (subject to them not declaring a bonus that would threaten their regulatory solvency). Requiring an accelerated return from them would mean a real risk of a successful judicial review. Action involving a wider group of companies enhanced the possibility of a collective industry challenge. There might be difficult questions about those companies whose 1997 returns were not prepared in accordance with the guidance now being issued and whether FSA would act against them. FSA's prudential division were clear that action to prosecute the companies for supplying improper returns would be a disproportionate response and in any event very unlikely to succeed. [The briefing was copied to the managing director but not to the conduct of business division.]

11/01/99

FSA, following advice from their legal division and GAD, told Equitable that Counsel's opinion had not changed their view of 07/12/98 that GARs must, as a matter of prudence, be fully reserved to within a few percentage points, even though changed economic circumstances had increased significantly the quantum of reserves required. The reality that the discretionary bonuses must continue to be adjusted, if policyholders were to continue to opt for the cash fund, substantially fettered Equitable's discretion not to pay additional bonuses. FSA said that they did not accept that DTI or the Treasury had had notice, as Equitable's Counsel asserted, that the GARs referred to in Equitable's regulatory returns made since 1993 were higher than the current annuity rates. If Equitable considered that the reserving requirement should not be enforced and intervention action not taken, clear and convincing arguments would be needed. Any arrangement falling short of the normal reserving requirement would need to be disclosed in the statutory return.

13/01/99

The Government Actuary issued guidance to all appointed actuaries (reference DAA11) reminding them to make proper provision for all GAR liabilities on prudent assumptions. Reserving requirements would be very similar whether a GAR was the principal benefit or only an option. It was necessary to reserve fully for all alternative benefits offered under the contract. It would not be prudent to assume that policyholders would choose a benefit form of significantly lower nominal value, although an allowance of a few percentage points could be made for other perceived advantages of alternative benefits. Where the terminal bonus was adjusted to bring the value of the GAR option closer to that of the alternative benefits, any reduction in reserves by more than a few percentage points below the full value of the GAR option would need very careful justification by the actuary. The need to hold mathematical reserves to cover GARs should not reduce the stringency of the resilience test to be applied. FSA and GAD would review closely the level of reserves established for GAR options in companies' 1998 regulatory returns.

FSA's prudential division wrote to the managing directors of life insurance companies saying that they had recently asked GAD to circulate to all appointed actuaries guidance on reserving for GARs. Managing directors were asked to review their financial position with their appointed actuary and tell FSA the outcome by 15 February. FSA pointed out that the 1997 regulatory returns for some companies did not conform with the new guidance. Those companies should submit their 1998 returns early, not later than 31/03/99.

The Treasury briefed the then Economic Secretary to note the circular and press notice that FSA were about to issue and to note the scope for criticism from with-profits policyholders who would mostly bear the reserving costs of GARs combined with the

liabilities for the costs of pensions mis-selling. FSA's concerns were to ensure that solvency was maintained and that policyholders' reasonable expectations were met. Additionally, the appointed actuaries must have sufficient independence and freedom to discharge their professional responsibilities, including advising the directors on protecting the interests and reasonable expectations of policyholders. In the first instance, FSA should answer any press or policyholder criticisms; the Treasury would only become involved if the adequacy of the regulatory framework or the performance of the regulator were to be called into question.

14/01/99

FSA issued a press notice saying that they had given all life insurance companies guidance on reserving for GARs and asked them to consider, depending on the information given in their 1997 returns, bringing forward publication of their 1998 returns.

15/01/99

Equitable sought a court declaration that article 65 gave them discretion to allot different amounts of terminal bonus to GAR policyholders when the applicable GARs were higher than the current annuity rates, so as to equalise the total value of benefits taken by any given policyholder.

The PIA Ombudsman began to tell complainants that he had concluded that Equitable had identified an important point of law and, in the circumstances, he should presently cease to consider and investigate complaints relating to Equitable guaranteed annuities by reason of the proceedings to be instituted in the High Court. He would keep the progress of the litigation under review.

18/01/99

An internal FSA minute from the head of advertising supervision to the head of conduct of business said that he was concerned that FSA had issued guidance (the prudential division's guidance to insurance companies on GARs of 13/01/99) representing the position of one part of FSA, when other parts of FSA had not had the opportunity to consider the matter properly. He said that that was particularly relevant when, as on this occasion, the conduct of business division's position might differ from that of the prudential division. Given the size of the GAR problem, the conduct of business division felt obliged to look closely and check whether any of the activity of the life insurers fell within their jurisdiction. They might decide that insurers had not done anything since 1988 which would fall under PIA's selling and marketing jurisdiction; on the other hand they might find something which they would feel obliged to pursue as part of their general brief to protect investors. Their instinct was to find out how the guarantees had been promoted to investors and, if appropriate, to require firms to honour their promises. The approach of FSA's prudential division was to preserve the financial soundness of companies by agreeing that bonus rates to GAR policyholders could be reduced, creating a clear conflict between conduct of business regulation and prudential supervision. The press notice reference to protecting policyholders had been a bit unfortunate. The author of the note said that he would hate to have to explain to a policyholder how they were protecting him or her by agreeing that the insurer could pay a pension substantially less than expected. He presumed that there was some mechanism within FSA to co-ordinate regulatory activity and asked if they should be noting their interest at a higher level.

Prompted by GAD, FSA's prudential division asked Equitable for further information about their reserves, assets and financial condition.

20/01/99

In an internal note, FSA's prudential division said that Equitable had said that they would reply to them on bonuses and financial reinsurance within a day or two.

Equitable expected the court case to be taken in late September, but an appeal could push it into the next year.

The conduct of business division circulated a note considering what their involvement should be in relation to guaranteed annuities. They noted that policies sold before 29/04/88 were probably outside jurisdiction. However, given the media attention, it seemed sensible to consider in more detail the issues raised by Equitable's treatment of GAR options to see if there was action that they should be taking to fulfil their regulatory obligations. Apart from any new sales after that date, top-ups of existing contracts or switching policyholders out of policies with GAR options might have generated documents providing information to policyholders about regulated products. Concern remained about the potential for conflict between the obligations of FSA's conduct of business and prudential divisions. The prudential division had interpreted the requirement for a company to meet policyholders' reasonable expectations to mean that GAR policyholders could reasonably expect to pay something for the benefit of the GAR. The conduct of business approach was to find out how guarantees had been promoted and, if appropriate, to require firms to honour their promises. There might thus be a clear conflict between the obligations of conduct of business regulation and prudential supervision.

21/01/99

Equitable replied to the prudential division's letter of 18/01/99 promising the data in a few days. They said that they planned to declare a 5% bonus for 1998, down from 6.5% for 1997. Equitable continued: "as you are aware, we have entered into a financial reinsurance arrangement with effect from 31 December 1998, as you helpfully suggested in your letter of 7 December 1998" [Treasury's insurance division had then agreed to accept reinsurance] with the aim of enabling Equitable to reserve at a level they felt prudently reflected their likely future experience. The appointed actuary would take up the matter direct with GAD to confirm that this would have the intended reserving effect. The reinsurance was a financing arrangement which would provide support to Equitable when more than 25% by value of the GAR business maturing in that year selected the GAR option. The cost was to be £150,000 per annum.

FSA's prudential division briefed the FSA Board on issues facing the insurance regulator, including the spiralling cost to the industry of meeting annuity guarantees. The Board noted that the Treasury remained responsible for prudential regulation until the Financial Services and Markets Act was implemented in full [01/12/01] (paragraph 6) and that any major change in policy would need to be agreed with them.

22/01/99

Equitable's appointed actuary told their Board that the lowest assumption as to the proportions of benefits taken as GARs that would not contravene GAD guidance was between 65% and 80%. Fewer than 1% of relevant clients had exercised GARs in 1998. In the absence of regulatory pressure, a suitably prudent assumption would be for 25% of benefits to be taken as GARs. He added that that was also the level of reserving the reinsurance arrangements being negotiated were intended to facilitate. He recommended a declared bonus for 1998 to be based on a return of 5%.

FSA's prudential division said in a briefing that Equitable was one of four companies giving cause for concern, principally due to GAR options. It was questionable whether Equitable would be able to declare a bonus. Equitable had agreed to discuss with FSA in advance any proposed bonus declaration. Based on GAD guidance, Equitable appeared to be just solvent with £1.15bn available assets covering a regulatory solvency margin of just under £1bn. They had sought and received an increased future profits implicit item of £1.9bn and were exploring the possibility of reinsurance for their GAR liabilities. Not to declare or to limit the annual bonus and to publish a low solvency position in April would be commercially damaging; their survival as an independent entity could be threatened. Should the court case go against Equitable their financial position could become even more precarious, and they might become liable to enhance past settled claims.

26/01/99

Equitable provided the additional financial information that FSA's prudential division had sought on 18/01/99.

FSA's prudential division asked Equitable for copies of papers relating to any bonus recommendations made to the Board within the previous 12 months and to the valuation by the appointed actuary at the end of 1997.

FSA's legal division told the prudential division, in the context of a draft reply to a Member's request for a copy of FSA's guidance, that any FSA decision on policyholders' reasonable expectations might be viewed by the courts as unfair if policyholders were not formally invited to make submissions to FSA on the matter. They also said that it would be helpful to see the papers relating to Equitable's court case. (FSA's prudential division did not request those papers from Equitable until June 1999.)

FSA's prudential division told their legal division of their strong preference not to reach a decision on policyholders' reasonable expectations until after the court case. The court decision would not preclude FSA from taking a view on intervention, but the judgment of whether or not policyholders' reasonable expectations had been met would depend crucially on the precise nature of the individual contracts, so that it would be sensible to await the court's decision on the legal position.

27/01/99

GAD commented to FSA's prudential division (copied to the legal division) on the financial reinsurance arrangement which Equitable were proposing. They said that they had no details about the financial strength of the reinsurer or what support, if any, the reinsurer's parent company might guarantee them. They said that the reinsurance treaty provided support to Equitable in any year when more than 25% (by value) of the guaranteed business vesting in that year chose the GAR option. It limited the reinsurer's overall exposure at any time to £100m. If claims were raised, Equitable would create a debt in their balance sheet and repay a recovery amount each year until the debt was fully repaid. The cost to Equitable was £150,000 per annum. Either party could cancel the treaty retroactively to the previous 31 December if certain contractual events occurred. The treaty could also be cancelled if Equitable changed their practice on GAR options which, GAD presumed, would include Equitable losing their court case.

At a meeting of the Tripartite Standing Committee (paragraph 37) FSA reported the dispute with Equitable about their reserving policy and the proposed bonus payments. They said that there were a number of options for handling this, including the possibility of reinsuring some liabilities, or limiting the bonus paid. It was agreed that FSA would continue discussions and report back to the next meeting.

28/01/99

GAD and FSA's prudential division met with Equitable to discuss the draft reinsurance agreement. According to FSA's note of the meeting, there were a number of issues of concern in relation to the drafting of the treaty, though it was considered that the treaty was capable of being revised so as to address each one. First, was the way in which the liability to the reinsurer was defined. Secondly, Equitable were unclear as to why it had been proposed that it should be possible for the reinsurer to cancel the treaty retroactively, and agreed that that would not be appropriate. Equitable agreed also to look to reduce the circumstances under which the treaty could be cancelled. Thirdly, there was a concern that reaching the £100m limit would trigger cancellation. Equitable said that that was not the intention, it was intended only to provide a right to review the terms of the treaty. If no agreement could be reached on revising the terms, the treaty would continue unamended. Equitable would look at redrafting the provision so that that was clearer. GAD emphasised that repayment of outstanding reinsurance claims should be subordinated to policyholder claims. Equitable asked how the reinsurance might be presented in the annual returns; they preferred not to show a reserve of more than £1bn for GAR options as they believed that that would be seen as indicating the real cost of those options to the company. FSA emphasised that their main concern was that the reserving basis should be clear from the returns. GAD had not yet determined the implications of the reinsurance treaty for the level of the future profits implicit item for which Equitable could take credit in their returns. Equitable said that they expected to use only the £850m originally applied for. They said that they expected to agree the revisions to the treaty during the following week and would supply GAD/FSA with the updated version. Following GAD's query of 27/01/99, the question was also raised as to whether Equitable were satisfied that the reinsurer was financially strong enough to fulfil the potential obligations under the treaty (to cover a potential £1bn+ liability). In response Equitable highlighted the reinsurer's AAA rating which GAD subsequently confirmed.

29/01/99

GAD told FSA's prudential division that they had been provided with copies of relevant Board papers relating to Equitable's proposed bonus declaration. They said that the papers showed that Equitable were sensibly seeking to balance a progressive

reduction in the additional guaranteed benefits each year with a reasonably competitive position and smoothing bonus declarations in line with the perceived expectations of policyholders. The cost of the declared bonus for 1998 would be some £365m; assuming that the reinsurance was completed, and that it was accepted by FSA as allowing a significant reduction in the reserves, Equitable would, based on their draft 1998 returns, cover their solvency margin by 250%, a similar level to that shown for 1997. Without the reinsurance, cover would be only 110%, though Equitable would then be able to take credit for a larger future profits implicit item. The financial position shown was likely, therefore, to appear reasonably satisfactory, though they would be potentially close to regulatory action for failure to maintain the required minimum margin if the reinsurance were not completed satisfactorily. It would be difficult to object formally to what Equitable were proposing though their position would need to be monitored carefully. They went on to say that the current reserving standard was not unreasonably harsh, with the possible exception of the resilience reserve requirement on GAR policies, which would be dealt with by the proposed reinsurance. When telling Equitable that they would not object to the proposed rate of bonus, GAD and FSA's prudential division should voice their concerns about Equitable's vulnerability and ask them to produce some contingency plans on how they would react to adverse investment conditions. GAD also noted that Equitable continued to issue annual notices to policyholders showing a high level of projected benefits and thereby generating further expectations.

GAD telephoned Equitable to discuss the valuation basis underlying a valuation result in an Equitable Board paper. GAD told Equitable that further discussion would be needed before FSA's prudential division would be able to accept that certain adjustments that Equitable were proposing to make to their valuations basis would produce acceptably prudent reserves. The discussion revealed that Equitable had included an allowance of £450m for future top-ups in their reserve calculation.

In a note of that call, GAD commented that Equitable now seemed to be accepting the ultimate need for full provisions, but appeared to be hoping to phase them in, and had suggested that the Treasury had given that idea a favourable mention at an earlier meeting. No further progress had been made on the draft reinsurance treaty, but Equitable saw no major problems arising and hoped to reach final agreement the next week.

01/02/99

FSA's prudential division wrote to Equitable, saying that it was important that they resolve the points of concern around the reinsurance treaty since, in the absence of a robust reinsurance agreement, it would not be prudent to declare any bonus for 1998. Without reinsurance, solvency margin cover would appear so low as to be easily eliminated by a small move in market conditions. If allowance was made for the proposed reinsurance treaty Equitable's financial position appeared significantly stronger, although even then Equitable would need to consider carefully the scope for declaring a bonus, given the uncertainties surrounding the financial implications of losing the court case. They should also take into account their heavy dependence on the reinsurance for solvency cover, and the risk of its being cancelled by the reinsurer by reason of losing the court case or for some other reason. FSA said that those were matters of judgement for Equitable in the first instance but, on the basis of the information provided, and assuming that the treaty were revised to resolve GAD's concerns, they were not minded to object to the proposed bonus declaration. They asked to be kept informed of progress on revising the terms of the reinsurance before reaching a final view on the proposed bonus declaration. FSA concluded that Equitable should not take FSA's decision not to intervene over the bonus declaration as an endorsement of what Equitable were proposing and added that they remained concerned about Equitable's ongoing financial health. They asked for revenue and solvency projections and contingency plans.

03/02/99

Equitable told FSA's prudential division that discussions with the reinsurers were proceeding and that they hoped soon to be able to provide a revised version of the treaty. They said that they had already considered their position in the unlikely event of losing the court case, and that they would be discussing that with their Board.

12/02/99

Equitable sent FSA's prudential division a copy of the draft reinsurance terms, saying that amendments had been negotiated to reflect the points made by FSA at the meeting on 28/01/99. They said that there now seemed to be no impediment to their proceeding with the planned bonus declaration.

Equitable sent a further letter in reply to FSA's letter DAA11 of 13/01/99 to all life assurance companies about reserving for GARs. Equitable said that their 1997 regulatory returns did not comply with the new guidance and that to achieve that, they would have had to use the full £700m future profits implicit item rather than the £371m that they had used in the submitted returns, to achieve the same result. The solvency margin would then have declined from 2.5 times to 2.0 times, but this would still have been consistent with the ratios that had given them an AA financial strength rating for the last five years. The reinsurance coupled with the full use of the £850m future profits implicit item would restore the margin to the level in the returns as submitted. In light of that, Equitable said, they saw no necessity for their 1998 returns to be submitted earlier than normal.

The managing director told the FSA Board that further consideration had been given to the position of those life companies affected by GARs and pensions mis-selling.

FSA's prudential division were giving particular attention to the case of Equitable, who normally declared their annual bonus in February.

16/02/99

FSA's prudential division told Equitable they still had one concern with the revised draft reinsurance agreement relating to the provision for settlement of claims. They wanted to see that issue resolved before Equitable declared a bonus, and they offered a further meeting later that week.

18/02/99

GAD told the prudential division that the revisions which Equitable had now faxed to them had not addressed all the points in their letter of 16/02/99.

The prudential division replied confirming that a meeting had been arranged with Equitable the next day to discuss and agree in principle the proposed reinsurance treaty. They said that they hoped that "we only ask for further changes [to the reinsurance

terms] if absolutely necessary, especially as we have already made requests that go further than what we had indicated we wanted in earlier discussions".

GAD agreed that they should keep to a minimum any request for further changes to the terms, but added that they should be very careful about giving firm agreement to the full effect of the treaty without seeing the final wording.

19/02/99

In his weekly report to the managing director, the director said that Equitable's bonus declaration was still subject to satisfactory reinsurance arrangements being put in place. If FSA were satisfied that the reinsurance was effective, Equitable were likely to approve a 5% bonus on pensions business - a drop of 1.5%, and at the low end of industry declarations, but better than had at one stage seemed possible.

22/02/99

FSA's prudential division told Equitable that their position remained unchanged: subject to the reinsurance treaty having the effect of allowing an appropriate offset to be made, FSA's prudential division were not minded to object to Equitable's proposed bonus declaration. However, they would still expect the points they had made to Equitable in their letter of 01/02/99 to be taken into consideration when deciding the scope for declaring a bonus.

GAD wrote to Equitable setting out the points covered in their discussion of 19/02/99. GAD confirmed that they accepted the principle of the reinsurance treaty allowing an offset if 25% of policyholders took benefits in GAR form, but said that they still needed to see the final version of it.

23/02/99

The court ordered that a named policyholder (Mr Hyman) should represent the interests of all policyholders in the matter of GARs, but said that that did not preclude a policyholder from seeking relief based on allegations about the way policies had been sold, if those allegations were based on facts not before the court.

24/02/99

FSA's prudential division told Equitable that their 1997 regulatory returns might have given potential policyholders a misleading impression about Equitable's financial position. They recognised that Equitable had taken action to address the situation but said that that had not strengthened the company's financial position to a point where it was as strong as had been presented in the 1997 returns. Equitable would have to rely on a much larger future profits implicit item in the 1998 returns, even with the reinsurance agreement, to achieve the same apparent solvency margin cover. Equitable were asked to agree by 3 March to submit the 1998 returns by 31 March 1999 or face possible regulatory action.

FSA reported to the Tripartite Standing Committee that they were still discussing Equitable's plans for reinsurance of some of the risks. If those plans were approved, then Equitable would pay a 5% bonus, which was at the lower end of market expectations.

26/02/99

The FSA director told the managing director in a weekly report that Equitable had now arranged satisfactory reinsurance which had cleared the way for them to announce a 5% bonus on most policies. They had also been invited to accelerate submission of their regulatory returns to the end of March.

Equitable agreed to submit early the 1998 regulatory returns.

03/99

Equitable rejected an approach made by another mutual life company for the companies to merge and then demutualise.

The FIA issued a position statement on annuity guarantees to enable its Officers, Council members and senior members of staff to respond to questions from the actuarial profession, members of the public and press. [The statement, which was placed on the profession's web site, was not formal guidance and said that it should not necessarily be taken as a full expression of the profession's views on the subject.] The statement said that the precise position of insurers in relation to their annuity guarantees would vary substantially depending on the exact wording of policy terms and conditions, references made in marketing literature and other representations made by the insurer on the subject. Companies needed to consider their individual position, and also to consider the reserves required in order to meet their policyholders' reasonable expectations. The Treasury's letter of 18 December 1998 demonstrated that there was considerable variation in how policyholders' reasonable expectations might be interpreted but individual offices might be constrained in different ways. The profession fully supported the regulator's position as set out in that letter. The Appointed Actuary of each insurer had a duty to ensure that sufficient reserves were held to meet that insurer's obligations under its own approach.

02/03/99

FSA's prudential division told their chairman that Equitable had volunteered to submit their 1998 returns early, but did not wish this to be divulged ahead of publication. Responses to the January guidance indicated that companies were now reserving for guaranteed annuities to a common minimum standard, which was an important safeguard for policyholders.

03/03/99

A firm of solicitors then acting for Equitable (Equitable's then solicitors) asked FSA's prudential division to confirm that the Treasury would consent to a proposed supplement to the subordinated loan agreement and to any consequent modifications to the section 68 order of 19/08/97.

05/03/99

FSA's prudential division asked GAD for advice on Equitable's request of 03/03/99.

18/03/99

The managing director told the FSA Board that FSA had been reviewing companies' exposure to GARs. He said that after setting aside reserves consistent with [FSA's] guidance, Equitable's free assets were so low that the prudence of paying a bonus that year had been questionable. Equitable had now put in place a reinsurance treaty to cover the additional reserving liability and would declare a reduced bonus of 5% (which he said was at the lower end of the industry range for 1999). They had also agreed to submit their regulatory returns early.

01/04/99

Equitable sent the reinsurer a letter of understanding, not intended to be legally binding, to clarify the intentions of the parties to the reinsurance treaty "incepting 31 December 1998". The letter said that if the withheld fund exceeded £100m, and no solution could be found under the Agreement terms, then the treaty would be cancelled. Equitable would not request a cash payment from the reinsurer for any item unless it was essential to satisfy regulatory requirements. The intention of the treaty was to create flexibility for Equitable in their reserving. [Equitable faxed this letter to FSA on 24/09/01; FSA told my investigators that neither they nor the new management of Equitable had previously been aware of the letter. FSA issued a press release to that effect on 26/11/01 and launched an investigation into why they had not received a side copy of the letter in April 1999.]