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Equitable Life Members & Policy-Holders
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The regulation of Equitable and the Reinsurance Treaty

A note for PASC by Nicolas J. Bellord Deputy Chairman of EMAG

1. My credentials

I am a retired Solicitor and Deputy Chairman of the Equitable Members Action Group. I wrote the 100 page submission of evidence to the Parliamentary Ombudsman on behalf of EMAG at the start of her inquiry. I was a member of the confidential committee of EMAG under the chairmanship of Colin Slater which liaised with the Parliamentary Ombudsman's office during the course of the inquiry. Whilst Colin Slater dealt with the very complicated actuarial matters I concentrated on the Chronology in its various drafts and I can claim to have read the Chronology in its draft and final forms at least three times! What follows is entirely based upon the Chronology which is Part three of the Parliamentary Ombudsman's report. (References to that Chronology are by the date of the entry).

2. Executive Summary

2.1 At the end of 1998 the regulators (the Treasury, Financial Services Authority (FSA) and the Government Actuary's Department (GAD)) were insisting that the Equitable Life Assurance Society (ELAS) find assets to cover the liability for the Guaranteed Annuity Options amounting to £1.6 billion. The GAD suggested financial reinsurance.

2.2. In January 1999 ELAS produced terms of such a reinsurance treaty which simply said a claim would arise but nothing would be paid in respect of such claims. When shown to the GAD they said to the FSA (Financial Services Authority) that the treaty did **"not achieve the intended reserving effect for a number of reasons"**.

2.3. What exactly did they mean by that statement? Were they saying that it was a complete fiddle and should not be allowed or were they saying that it was a fiddle that needed **"window-dressing"**? Examination of the Chronology in the Parliamentary Ombudsman's report leads one inexorably to the latter interpretation. During the following months the GAD entered into talks with ELAS to modify, amend and lengthen the treaty finally agreeing to it. The Treasury, the FSA and the GAD in their response to the PO say that that version of events was entirely correct. The GAD fathered the treaty and acted as midwife in bringing it to birth. However well before the GAD had agreed the terms of the treaty the Director of Insurance and the Managing Director of FSA reported to the board of the FSA that ELAS had entered into a satisfactory agreement.

2.4. Nobody, in their right minds, looking at the tiny premium payable (initially £50,000) or the terms of the treaty could have thought that it secured cover for £1.6 billion. The Parliamentary Ombudsman said that the acceptance of the treaty by the Regulators **resulted in the true financial position of the Society being concealed and misrepresented through the publication of returns which contained a misleading picture of the Society's solvency position.** She found maladministration leading to injustice as a result. That was the limit of her function as Ombudsman.

2.5. However does this connivance and assisting in **window-dressing** by the regulators leading to concealment and misrepresentation not raise much more serious questions than just maladministration? According to the PO the acceptance of the reinsurance treaty was a **"critical juncture"** in the whole story. It can fairly be said that up to that point there was regulatory failure – maladministration – but here we move into more serious delicts to be followed by a litany of attempts to hide the truth, prevaricate and further the injustices done to the policyholders. Is it not at that point that questions of misfeasance, malfeasance and possibly fraud arise? To what extent the Ministers then in charge of those departments were aware of what was going is not clear; however an explanation and acceptance of responsibility from them is, at the very least, surely required.

3. The story as from the Chronology in Part 3 of the Parliamentary Ombudsman's report

3.1. The Guaranteed Annuity Rate (GAR) crisis

3.1.1. At the end of 1998 the regulators were insisting that ELAS establish reserves of £1.5 billion to cover their exposure to the extra costs of GARs as interest rates fell. The seriousness of the situation was such that failure to establish such reserves would mean not being able to announce in 1999 a bonus for 1998. This would have been "commercial suicide". Further if the insurance return for 31st December 1998 revealed an inability to cover the Required Minimum Margin of assets over liabilities the regulators would consider closing the Society.

3.1.2. In the entry for 03/12/1998 Christopher Headdon, ELAS's Appointed Actuary, said he was considering the use of reinsurance as suggested to him by the GAD to cover this risk but it would be difficult to arrange this by the end of the year. At that meeting HMT 'thought it would be possible to give a concession so that the effect was post dated to cover the 1998 year end position'. The Treasury wrote on 7th December 1998 that they "would be willing to consider the possibility of treating any such reinsurance arrangement as having been effective" as at 31/12/1998 provided *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.*

3.1.3. On 31st December 1998 ELAS told the Treasury they had an offer of reinsurance from IRECO at a premium of £50,000 per annum plus 2% of any claim to insure a possible liability of £1,500,000,000, which represents an initial premium rate of 0.0033%. It would have been like being made an offer to insure one's house for say £400,000 at an annual premium of £13 when there is already a forest fire just

down the road. Further any claim paid was to be repaid in about 3 years! But then claims were not actually to be paid but just recorded.

3.2. Crafting the Reinsurance Treaty

3.2.1. From 31st December 1998 until April 1999 a process of the regulators vetting the reinsurance treaty and getting it amended took place. Initially the treaty seems to have consisted of two simple clauses effectively saying:

- a. Claims would arise in certain circumstances connected with the Guaranteed Annuity Rates.
- b. No payment would be made in respect of such claims.

3.2.2. Evidently the GAD thought this was too obviously not going to be satisfactory and suggested amendments. They entered into discussions with ELAS who were advised by an actuary from Ernst & Young in order to ensure that the treaty was revised – what was subsequently referred to by the FSA as “window-dressing”. The treaty as finally signed was a complete sham. It is so complex as to be incomprehensible as to its effect. Important clauses in the body of the document are reversed in their effect by small print in the appendices etc etc. It would appear from the Chronology that no lawyer from the regulators looked at the treaty until two year after it was signed in October 1999. The treaty is just designed to deceive and confuse. It appears in Part Four of the PO’s report at page 1018.

3.2.3. In the course of this negotiation it was evident that the FSA were very keen to ensure that agreement as to the terms of the treaty took place as soon as possible. In February they were pressing the GAD not to ask for further changes unless they are absolutely necessary. Despite agreement not having been reached on 26th February 1999 FSA’s Director of Insurance informed the Managing Director of the FSA that ELAS had now arranged satisfactory insurance for its GAR liabilities. He also said that this had cleared the way for ELAS to announce a bonus the following week. The Managing Director of the FSA repeated this false information to the Board of the FSA on 18th March 1999. The position was being reported monthly to the Tripartite Standing Committee but there is no record of what exactly was being said to them at that point.

3.2.4. What is absolutely clear is that from the beginning right through to the treaty being signed on 11th October 1999 and the subsequent amended versions of the treaty is that there was no question of any claim being paid in any substantial amount remotely relevant to the possibly liability for £1.6 billion which was supposedly being reinsured against. The treaty was designed to create a pure fiction and in cash terms was to impose a substantial extra burden on ELAS with no compensatory cash benefits. It was designed to mislead the public at large into believing that the Equitable had sufficient assets to cover its liabilities to pay pensions by making fictional entries in the return. ELAS had been holed below the waterline. The reinsurance treaty was not designed to patch the hole but to give an air of normality by rearranging the chairs on the promenade deck.

3.2.5. On 25th March 1999 the GAD said the treaty was worth £1.5 billion. In their insurance return for 31/12/1998 filed on 30/03/1999 ELAS claimed that they could use the treaty to cover £809 million of liabilities.

3.2.6. When GAD came to scrutinise the return [08/04/1999] they noted that they needed to be satisfied as to the terms of the treaty and to get a copy of it. They asked the FSA to do that. On 15th April 1999 the FSA asked ELAS for a copy of the treaty but just got a copy of the term sheet on which it was based. They did not chase ELAS again for a copy of the treaty itself until 28th September 1999.

3.2.7. On 27th April 1999 the GAD examined the term sheet supplied by ELAS and did not raise any objections. The same actuary in the GAD who failed to object to the terms in April later noted in October 1999 his lack of objection in April as being approval of the treaty.

4. The Parliamentary Ombudsman's findings on the story up to October 1999

4.1. The Parliamentary Ombudsman recounts the story in Chapter 7 of her Main Report being Part 1 starting at paragraph 17 on page 140.

4.2. The PO then relates her findings of fact in Chapter 10. Specifically the reinsurance treaty is dealt with at page 273. She mentions that the concession proposed at the meeting on 3rd December 1998 would have been under s.68 of the 1982 Act.

4.3. The PO points out that the GAD raised a number of points on the treaty and says at para 413 on page 275: "None of these matters were the subject of substantive amendment in the terms of the agreed slip ... or in the treaty..." Yet "the FSA permitted the Society, without challenge, to take a reinsurance offset of £809 million within its 1998 returns – without any concession under section 68 of the 1982 Act". She also mentions that the FSA made no adequate attempt to ascertain the financial strength of IRECO.

4.4. The PO gives her assessment of the facts (paras 429ff, pages 277ff). She first of all says that the treaty had not been entered into on 31st December 1998 and in the absence of a reporting concession under s.68 of the 1982 Act the regulators should not have allowed the Society to make use of the treaty within its 1998 return (para 432). The Parliamentary Ombudsman then goes on to say that the reinsurance treaty was not a contract for reinsurance because the only payment that might have been made by IRECO was in the form of a loan and was therefore not an indemnity. As it was not a contract for reinsurance then it could not be used, in view of the applicable Regulations, to reduce the reserve for the guaranteed annuity rate. She concludes: **I consider that the Society should not have been permitted to take any credit for this arrangement in any of its returns for 1998, 1999 and 2000** (para 450 page 279).

4.5. The response of the public bodies or regulators to this finding follows on page 279ff. They do not attempt to say that the GAD objected to the form of the

reinsurance treaty but rather that the GAD had assisted in the drafting of the treaty. At para 457 on page 280 they are reported as saying:

(c) The detailed terms of the reinsurance had been amended a number of times to comply with the requests of the prudential regulator and GAD, over a period of many weeks, and all the points which they considered needed to be addressed in the final terms of the contract to achieve the desired reserving effect in the returns had been advised to Equitable over a month previously.

4.6. The regulators did not claim that ELAS did other than comply with all these requests once so advised. The regulators claim that the reinsurance treaty was in perfect order. This misleading and deceitful treaty, which provided for no substantial payment in respect of any claims relating to risks supposedly covered, was just as much the carefully nurtured baby of the GAD and the FSA as it was of ELAS.

4.7. As to the overall effect of the treaty the public bodies wrote (page 113 Part 4 of the PO's report) as follows:

228. HMT, FSA and GAD disagree fundamentally with this view. FSA have sought fresh advice on this, and are satisfied – as they were at that time – that both European and domestic legislation permitted contracts in this form to be given a value in determining the regulatory solvency position of insurance companies. In acting as it did, the prudential regulator acted in accordance with the Statement of Recommended Practice subsequently issued by the Association of British Insurers in 2003.¹¹⁴ Whether a contract between an insurance company and a reinsurer is properly to be regarded as a contract of reinsurance is sometimes not an easy question. Even if Lord Penrose's view is right, however, (and it is emphasised that this is disputed), the view taken by the regulator cannot be said to have been an improper one at the time.

4.8. The above defence written in December 2004 contrasts blatantly with what the FSA had written in July 2002 in consultation paper 144 "A new regulatory approach to insurance firms' use of financial engineering." :

"Practical examples of this have arisen by virtue of side letters which negate the value of the main contract but which are not disclosed or allowed for in reported results. These arrangements are clearly the most unacceptable. Some may even say deliberately misleading and there will typically have been nonobservance of existing regulatory and other requirements. The ABI SORP, for example, requires 'entire arrangements' to be taken into account. In these situations what is needed is better tools and warning indicators to help supervisors and auditors to spot potential transactions warranting further scrutiny. Classic warning signals will be large credits for apparently low cost."

4.9. The above was quoted by Lord Penrose in his report at Chapter 7 para 107. It correctly describes, what the public bodies are now trying to justify, as **“deliberately misleading ”** with **“non observance of existing regulatory and other requirements”**.4.10. The PO’s finding appears at para 486 on page 285:

My finding

486 I find that the failure by the FSA, acting on behalf of the prudential regulators, to (i) ensure that the financial reinsurance arrangement was not taken into account within the Society’s 1998 returns without an appropriate concession being given, and (ii) ensure that the credit taken by the Society within its returns for 1998, 1999 and 2000 properly reflected the economic substance of that arrangement, fell short of the standard that could reasonably be expected of such regulators.

The credits allowed for 1998, 1999 and 2000 were £809m, £1098m and £808m respectively.

4.11. The PO goes on to find that these findings reflect maladministration at para 101 on page 326 Chapter 11:

101 I consider that the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society’s 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement, constitutes maladministration. I therefore make such a finding of maladministration against the FSA.

4.12. The Parliamentary Ombudsman labels this as her sixth finding of maladministration and she spells out the consequences in paras 38 to 43 on pages 339 and 440 Chapter 12.

4.13. Para 42 is particularly relevant:

42. The maladministration which I have found resulted in the true financial position of the Society being concealed and misrepresented through the publication of returns which contained a misleading picture of the Society’s solvency position.

Concealment? Misrepresentation? These words raise questions beyond the PO’s remit which is to look at maladministration and whether it leads to injustice. Do they not suggest misfeasance or even malfeasance?

4.14. The Parliamentary Ombudsman considers injustice in paras 122 to 145 on pages 348 to 350 Chapter 12. She says that the becoming available of the 1998 regulatory return on 1st May 1999 represented a **critical juncture** in the whole ELAS story. Her conclusion was:

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

4.15. The Parliamentary Ombudsman's jurisdiction is limited to finding injustice arising from maladministration. Others will ask whether the regulators, having been undoubtedly guilty of maladministration, at that **critical juncture** did not become guilty of deliberate concealment and misrepresentation in assisting and conniving with ELAS with regard to the reinsurance treaty.

5. Queries start to arise

5.1. In the Autumn of 2000 the sale process was taking place. One of the bidders asked some awkward questions [06/11/2000] of the FSA and the GAD:

'The company [the bidder] ask about FSA's and GAD's view of various financial reinsurance instruments, suggesting that Equitable's agreement has some risks. GAD confirm that they studied the agreement and did not object. FSA and GAD explain that they do not support arrangements *'which take advantage of regulatory arbitrage'*. The company's advisers point out that Equitable's reinsurance treaty falls into this category. They also express concern that the reassurer has the right to terminate the arrangement if Equitable become insolvent. GAD note that they are examining the treaty in this respect (see section 3 of GAD's scrutiny report on the 1999 returns, 24/11/2000).'

5.2. So the FSA and the GAD were saying that they do not support regulatory arbitrage. And yet IRECO was a company in Ireland which because it was the subsidiary of a foreign company (General Electric) was not regulated at all. So why were they "supporting" this particular treaty which was based on regulatory arbitrage? The reference to the scrutiny report on 24/11/2000 points to the statement that the treaty "is not wholly satisfactory from a regulatory perspective, as it relies on regulatory arbitrage".

5.3. The sale process collapsed in early December 2000 and on 13th December 2000 The Independent published an article questioning the reinsurance treaty and why it was allowed. The GAD responded :

'A reinsurer takes a commercial view of the situation reflecting, for example, the fact that policyholders might prefer to receive lump sum and take a reduced pension or to take their pension in a more convenient form than that offered under the GAR. The reinsurance is an effective and legitimate way of taking liabilities off the balance sheet of the Equitable by transferring the

top slice of the liability on GARs to the reinsurer. In other words, the Equitable ends up setting up a liability on its balance sheet calculated on the commercial basis (reflecting a GAR take-up rate of 60% in the Equitable case) and the reinsurer bears the risk and cost if more than 60% of policyholders take the GAR.

[15:51] FSA's Head of Press Office replies: *'I'm sorry, but this does not really help in killing the story nor the implication it carries (that we helped a cover up). We need a rebuttal of the points in the Independent article. [An official from the Press Office] is on the way to talk to [the Director of Insurance] about it. We need clearer and more robust lines.'*

5.4. The FSA requested the GAD to prepare a report on ELAS in response to press coverage and this was provided on 19/12/2000. As to the reinsurance treaty the GAD said:

'Such treaties continue to depend on regulatory arbitrage to achieve the desired result. (It is unlikely that the reassurer, Irish European, will currently be setting up compensating reserves to those removed from the balance sheet of the Equitable ...

'The reliance on an offshore reassurer, and the cancellation clause leave the treaty as a more controversial device by the Society, but the treaty has been accepted as satisfactory in statutory reserving terms up until now.'

5.5. So the GAD saw IRECO as possibly having no reserves to cover the amount they have allegedly reassured for and justified the acceptance of the treaty on the grounds that they had previously accepted it!

5.6. On 12th January 2001 Private Eye joined in the criticism:

They 'not only failed to ensure that the world's oldest insurer did not topple into a multi-billion "black hole" but also persuaded Equitable's auditors, the Financial Services Authority and the Treasury to confidently permit the society to carry on selling new pension policies even when it could not meet its obligations under the old ones'.

5.7. Somebody in GAD commented that there was a grain of truth in that.

6. The reinsurance treaty unravels

6.1. After the flurry raised by outsiders in December/January 2001 no mention was made of the treaty until 7th August 2001 when the newly Appointed Actuary at ELAS wrote to the FSA with a copy of all the correspondence relating to the reinsurance treaty and asking whether the FSA were satisfied *that the attached describes the position from your point of view and that you have nothing to add.* The Appointed Actuary, Peter Nowell, evidently thought it was all very odd but the FSA in replying had nothing to add.

6.2. There then arose the question of a side letter which had been written by ELAS to IRECO the reassurers on 1st April 1999 but was only disclosed to the regulators in September 2001. At the letter was expressed to be of no legal effect its effect was illusory but it caused the FSA to start thinking about the validity of the treaty and if it

was invalid that ELAS was regulatorily insolvent. They even considered informing the Serious Fraud Office but did not do so perhaps for obvious reasons. However it was at this point that lawyers, for the first time, began to examine the reinsurance treaty – two and a half years after the regulators had given it the nod.

6.3. It was at this time that the s.425 Compromise was starting to go ahead. Despite the increasing doubts about the reinsurance treaty the FSA did not think that it was relevant to tell anyone about their doubts.

6.4. On 15th October 2001 [12:44] it was said that an outside QC had advised that ELAS should not be allowed to use more than £100 million in respect of the treaty. There were difficulties resolving the issue of the side-letter between ELAS and IRECO and this was seen as possibly delaying the compromise scheme [22/10/2001 morning] and the convening meeting at the Courts was postponed. ELAS asked the FSA to lean on IRECO.

6.5. The FSA met IRECO's parent company (General Electric) on 1st November 2001. General Electric **“said that the treaty was always intended to be a riskless transaction”**. **That meant that it was worthless**. Negotiations continued and on 5th November the FSA's chief lawyer commented: *“Don't think it helps much to put in place a riskless deal for the future – hope that's not what's intended”* [05/11/2001 10:31]. Despite this the FSA approved a revised version of the treaty but with the caveat that they did not know what it was worth. An actuary within the GAD commented:

‘overall reaction is that this arrangement is little more than “window dressing” and the reinsurer has no intention of assuming any serious risk at all’.

6.6. When the FSA had finally done their sums and Counsel had advised that the treaty was not a reinsurance treaty at all it was realised that the treaty was worthless. Nonetheless ELAS claimed £695m in their balance sheet for 31/10/2001 delivered to the FSA on 26/11/2001.

7. Conclusion

7.1. Obviously we are only told part of the story and one has to speculate as to motivation. There is no doubt that at December 1998 the Equitable Life Assurance Society was facing the gravest crisis in its history. If it could not find reserves to cover the GAR liability, then it would have to pass declaring a bonus and was in imminent danger of being shut down by the Regulators. A Reinsurance Treaty was proposed by the regulators to save the day. One would have thought that the strictest possibly scrutiny would have been applied by the regulators to ensure that the treaty provided genuine security for the pensions of well over a million people. Even though the initial premium on the one and a half billion pounds risk rose from £50,000 to £400,000 before the treaty was signed it was still so ludicrously little that nobody could have interpreted the treaty as other than a sham.

7.2. What was the real agenda? The Director of Insurance informed the FSA's Managing Director, that ELAS had arranged satisfactory reinsurance just in time to

announce the bonus for 1998 when in fact the GAD had raised these objections which remained unanswered. The Managing Director repeated this to his Board.

7.3. Was that other agenda, spoken or unspoken, that the Equitable had to be kept going at all costs and if the device which saved it was a sham it was best to turn a blind eye to that fact? There is no evidence of anything being said or written explicitly along those lines. If there was no such agenda, when the bidder for the Society drew attention to the “regulatory arbitrage” aspect in November 2000 why was no further action taken? If the treaty was thought to be genuine then why the cynical remark that IRECO would not *“be setting up compensating reserves to those removed from the balance sheet of Equitable”*? How did The Independent and Private Eye get hold of the story that the reinsurance treaty should not have been allowed if there was not someone in the regulators who was prepared to leak the story because they did not like it?

7.4. The newly Appointed Actuary in ELAS, Peter Nowell, obviously thought there was something fishy about the treaty when he had a chance to examine it.

7.5. There can be little doubt about the guilt of the regulators when one comes to the autumn of 2001 and the s.425 Compromise which was coming before the Courts. Despite their increasing doubts about the treaty they saw nothing wrong in allowing the compromise documents to be sent out for consultation with no mention of their doubts about whatever value the treaty had. The lawyers argued about the treaty with the actuaries and line managers but eventually their Senior Lawyer agreed to a renegotiated treaty because it created a totally fictitious entry in the accounts which, they claimed, was sufficient to create an actuarial benefit. Having agreed to the treaty in principle they set about doing their sums to see what value could be put on the treaty eventually saying it is worthless. Do they tell anyone – the Court, the policyholders or the Press about this? No. Was this the degree of honesty that a Court would expect? Why should one not therefore believe that they acted dishonestly throughout from the moment the reinsurance treaty was proposed so that Equitable could be kept going at whatever cost? Lawyers are known to have said that the treaty was “contrary to public policy, illegal and void”. This is unusually strong language usually referring to dishonesty and bad faith.

7.6. These are the revelations to be obtained from a close reading of the Chronology. They raise a question which is much more serious than just whether there was maladministration by the regulators. Was there a deliberate connivance by the Treasury, the FSA and the GAD in assisting ELAS to mislead and deceive the policyholders? That is a question which demands an answer from the Ministers concerned. This note is based upon a very detailed analysis of the Chronology and other documents obtained under the Freedom of Information Act. We would be happy to supply that analysis should it be required. A second question is whether there was a cover-up of this episode. That is something which EMAG could enlarge upon again based on the Chronology.

Nicolas J. Bellord 5th December 2008.