

**MEMORANDUM TO THE PUBLIC ADMINISTRATION SELECT COMMITTEE  
BY THE EQUITABLE MEMBERS ACTION GROUP LIMITED -"EMAG"**

**INTRODUCTION**

- 1 Equitable Members Action Group (EMAG) is the only substantial Equitable Life policyholder group, with a proper constitution, a money subscription and an elected Board of Directors. It has over 15,000 members.

We welcome the opportunity to give evidence to the Public Administration Select Committee on the prudential regulation of Equitable Life and the report of the Parliamentary Ombudsman ("the PO").

- 2 This memorandum draws attention to the financial costs of the compensation recommended by the PO in her report presented in July 2008. Most of the detailed computations have been prepared by Colin Slater FCA, partner in Burgess Hodgson, Chartered Accountants and a member of the Board of EMAG.
- 3 Colin Slater FCA with Paul Braithwaite (Secretary General and director of EMAG) and Ann Berry a with-profits annuitant will be giving oral evidence to the Select Committee.

## EXECUTIVE SUMMARY

- 4 The Parliamentary Ombudsman (PO), made 10 findings of maladministration against the regulators amounting to 'serial regulatory failure' covering the period from 1991 to 2001. She recommended that compensation be based upon 'relative' losses incurred by comparison with investment 'elsewhere'. The PO made no estimate of the aggregate losses incurred or the cost to the public purse.
- 5 EMAG has undertaken such a comparison and estimates aggregate losses incurred by policyholders up to 2001 at about £4,800m. The basis of this calculation is the published results of the average competitor company; a similar calculation was undertaken by a firm of actuaries on behalf of the FSA in 2001 and arrived at nearly the same figure. We have added to this the costs incurred by policyholders in moving their funds elsewhere, increasing the losses to about £5,850m
- 6 Many of the Parliamentary Ombudsman's findings refer to loss of opportunity. We have dealt with this in much the same way that the Courts deal with 'loss of a chance' cases. Effectively they apply a discount to allow for the possibility that the profit expected to derive from the chance might not have materialised.
- 7 We have also applied a discount for the fact that the Directors of Equitable Life were primarily responsible. But the regulators allowed a problem with a small company with £5bn of assets to escalate over a decade to one with £30bn and more problems. Because they then adopted a tactic of cover-up and delay we have, on leading Counsel's advice, applied a small discount of 10%.
- 8 After discounts we estimate the loss for compensation at £3,316m and after adding interest to July 2008 the cost to the public purse becomes £4,666m. We stress that this is a simplified outline calculation derived from public information and using reasonable estimates. It could be improved and refined with access to Equitable Life and FSA information, which MPs could request.
- 9 It would greatly simplify and accelerate distribution if Parliament ordered that the aggregate amount of compensation, which it thought appropriate, should be paid to the proposed Compensation Tribunal. This would also cap that amount. That body would be under the control of Parliament and, if properly constituted, be responsible for effecting distribution amongst policyholders in a fair, transparent and speedy manner.
- 10 A claims system would be totally inappropriate. This would not recognise, those who have died, the age of the policyholders, their number and incidentally would lead to a windfall for professional advisers. Parliament could also arrange a simplified tax treatment
- 11 Lord Penrose found that 'principally, the Society was author of its own misfortunes'. However he also concluded that 'the standards of scrutiny [by the regulators] still impress me as complacent, lacking challenge, and hesitant in criticism and in following up on any criticism made', a view confirmed by the PO.

## **WHAT LOSSES DID POLICYHOLDERS INCUR AND HOW MUCH WILL COMPENSATION COST THE PUBLIC PURSE?**

- 12 The PO's central recommendation regarding compensation is reproduced below:

'9.27 My second – and central – recommendation is that the Government should establish and fund a compensation scheme, with a view to assessing the individual cases of those who have been affected by the events covered in this report and providing appropriate compensation.

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

9.29 I consider that addressing relative loss in this way would be the most appropriate remedy for the injustice that I have found resulted from maladministration. Such an approach would remedy any financial loss that has occurred and also the loss of opportunities to invest elsewhere than the Society. It is thus not necessary to give further consideration to what additional remedy it would be appropriate to recommend to remedy the lost opportunities that have been sustained.'

- 13 It will be observed that the PO's recommended method is to compute 'relative' losses by comparison with investment 'elsewhere'. That is all she says on the matter. 'Elsewhere' may well mean a basket of competing policies. [For convenience, we refer to this as 'Elsewhere Life'] She regards the detailed computation as a matter for another day and for a different body, perhaps the proposed Compensation Tribunal.
- 14 The PO makes no estimate of the aggregate losses incurred or the cost to the public purse. EMAG addressed both these issues in its May 2008 submission to the PO, which is reproduced in her report and which is updated below in the light of her final report and her recommendations upon redress.

### **Investment Elsewhere**

- 15 The published indications are that Elsewhere Life actually performed rather better than Equitable. Our information predominantly comes from Money Management. This is a widely read and respected trade magazine owned by the Financial Times. It performs twice yearly pension surveys and the results cover all the big players in the market, unfortunately excluding Equitable Life since its closure to new business.
- 16 The table on Appendix A shows the performance of £10,000 investments in Money Management's average fund at the beginning of each of the years 1990 to 2000 inclusive. Maturity is assumed at the beginning of each of the years 2000 to 2002. It also shows the results of a comparable Equitable Life policy and the relative loss for each year of investment and maturity.
- 17 The results for early 2000 maturities are significant in that the Equitable Life figures include the 1999 bonus, the last one before bonuses were distorted by the attempts to restore the position. Even then, the Society's past performance record was below the market average by about 1%p.a. compound. Its subsequent performance has been horrendous. Terminal bonuses were virtually eliminated by the 16% policy value cut of July 2001, which was back-dated to 31 December 2000, and the two smaller cuts (4% and 6%) in 2002.

- 18 The table below combines the relative losses shown at Jan/July 2001 per £10,000 of premium with our estimate of premiums remaining in force at that date and quantifies the aggregate loss at about £4,800m. [Column C = Column A x Column B/10,000]

Investment	Remaining Premium £m A	Total Value £m	Losses to Jan-01 per £10k premium B	Loss from Jul 1991 £m C	Loss from 1993 £m	Loss from 1988 £m
pre 1990	N/A	4,641				550
1991	470	1,154	8,692	204		408
1992	656	1,456	7,517	493		493
1993	868	1,733	6,254	543		543
1994	1,016	1,825	5,647	574	574	574
1995	1,406	2,302	4,782	672	672	672
1996	1,913	2,855	4,080	780	780	780
1997	2,437	3,274	2,548	621	621	621
1998	2,649	3,200	1,746	463	463	463
1999	2,581	2,819	1,120	289	289	289
2000	2,108	2,142	768	162	162	162
	<u>16,105</u>	<u>27,401</u>		<u>4,801</u>	<u>3,561</u>	<u>5,556</u>

- 19 Examination of the July 2001 chronology contained in the PO's Report reveals that the FSA itself commissioned a report from a firm of actuaries on the cost of the GAR claims. This was similarly based upon the assumption of investment in 'Elsewhere Life' in respect of premiums paid from 1988. The actuaries' report has not been reproduced, but the compensation figures it arrived at were quoted.

23/07/2001 [17:54] The Head of Actuarial Support says that 'If they [Equitable Life] are likely to incur mis-selling claims on all post-1993 policies, then the liability could be around £3-4 billion.... If the potential claims extend back to 1988 or even earlier, then the situation is clearly even worse.'

25/07/2001 [entry 8] FSA's Chairman told the Tripartite Standing Committee of the Treasury, the Bank of England and the FSA 'that something between £3[bn] and £5bn would [be needed to] make [Equitable] solvent.'

- 20 The amounts for the post 1993 and post 1988 periods, using our estimates, are shown in the right hand columns and are compatible with those of the FSA's actuaries. Their report is referred to as having been dated 13 July 2001, 17/07/2001 [entry 3].
- 21 In EMAG's view, this is an important contemporaneous document, which the FSA should now publish for the guidance of Members of Parliament, policyholders and the proposed Compensation Tribunal.
- 22 At this stage the committee might reasonably ask how it was, if Equitable Life was paying bonuses that were too high, that its performance was worse than that of competitor companies. The answer is complex:
- Other companies either did not suffer the GAR problem, or suffered it in a much less extreme form than Equitable Life.
  - Over-bonusing related primarily to premiums paid before 1991, when the PO found that mal-administration commenced. Premiums paid after that time

- suffered because the Society tried to recover previous excesses from their bonuses. GAD's 1998 report on the life insurance industry noted a sharp fall in payouts over the 5 years then ended. [Chronology Page 404]
- c) Competitors with stronger funds were able to invest more heavily in equities, which performed well.

### **Loss Mitigation Costs**

- 23 The losses relative to investment in Elsewhere Life are calculated above upon the assumption of contractual departure in both cases. In practice, however, during the period from 2001 to 2004 something over half of policyholders by value moved their funds elsewhere and those that could not do so upon a contractual maturity date also suffered departure penalties. These took the form of Market Value Adjustments and deduction of the balance of the policy value cuts which could not be dealt with out of terminal bonuses. Many also incurred charges for re-investment in Elsewhere Life.
- 24 The vast majority of non-contractual leavers did not go for reasons of personal choice, for example because they were retiring or needed the cash for children's education or for moving house. They left to protect themselves from yet more financial pain to come. They took the view that such pain would be more costly than the various departure penalties. The Parliamentary Ombudsman's finding of serial regulatory failure strongly justifies their action.
- 25 Complainants have a legal duty to mitigate (minimise) their future losses and the costs of that mitigation are treated as part of the total loss, which is eligible for compensation.
- 26 Without access to the details of actual departures we cannot determine the precise cost to policyholders, but we would mention that:
  - a) Over half the fund, perhaps £13,000m, was lost to departures over the 2001-2004 period.
  - b) About 45% of such departures (say) £5,800m are expected to have been non-contractual and have suffered the balance of the July cut and market value adjustments.
  - c) Most such monies would have suffered charges for re-investment elsewhere.

We estimate the aggregate of loss mitigation costs to have been of the order of £1,050m.

### **Loss of Opportunity**

- 27 Many of the Parliamentary Ombudsman's findings refer to loss of opportunity. In particular the PO considers that the maladministration of allowing misleading returns to have been published lost policyholders the opportunity to have invested elsewhere. In short, if policyholders, advisers and commentators had known the true weakness of Equitable Life's finances, then a large proportion of subsequent premiums and in some cases the existing fund would have been invested elsewhere.

- 28 We understand that the PO intends 'loss of opportunity' to be interpreted in much the same way that the Courts deal with 'loss of a chance' cases. Effectively they apply a discount to allow for the possibility that the profit expected to derive from the chance or opportunity might not have actually materialised. In this case the factors affecting the expected profit are:
- a) Whether policyholders, had they known the true state of Equitable Life's finances would have actually taken the opportunity to invest elsewhere.
  - b) The possibility that the alternative investment could have performed worse.
- 29 Estimating the discount is by no means an exact science. Detailed examination of a sample of individual cases would be one approach to arriving at an estimate. Indeed the PO attempted such an approach by looking at the percentage of cases dealt with by the Financial Ombudsman Service which generated a loss. In the two samples she looked at 60% and 78% were found to have suffered a relative loss.
- 30 Although EMAG in no way accepts the FOS's methodology, this research supports our view that about 70% of cases would have taken the opportunity to invest elsewhere, indicating an appropriate discount of 30%. We have applied a further 7% discount to allow for the possibility of Elsewhere Life performing more badly.

### **The Public Purse / Regulatory Contribution**

- 31 PO recognised the magnitude of the scale of compensation, which she recommended, but left it to Parliament to decide how to deal with it.
- '9.37 I recognise that the public interest is a relevant consideration and that it is appropriate to consider the potential impact on the public purse of any payment of compensation in this case.
- 9.38 Furthermore, I am acutely conscious of the potential scale of what I have recommended and that acceptance of my central recommendation might entail opportunity costs elsewhere through the diversion of resources.
- 9.39 In that context, I invite Parliament to consider the issues that have been raised in this report and the recommendations that I have made and to further reflect on what its response to my report should be.'
- 32 EMAG is advised that in cases of maladministration it is traditional for those found guilty to meet the whole cost of the loss, even though others were partly responsible. However, in a case such as that of Equitable Life where the amounts are very substantial indeed and where the primary responsibility for the Society's demise rested with its directors, the matter of whether it is reasonable for the public purse to bear the whole cost does need to be considered.
- 33 Lord Penrose demonstrated that in the early 1990s the directors voted bonuses substantially out of proportion to the Society's profits and assets. This was done in order to maintain the Society's marketing advantage. The responsibility for this must lie primarily with the directors. It must, however, also be pointed out that at this stage the Society was relatively small in size and with total funds of about £5 billion.
- 34 The financial weakness that excess bonuses created made it difficult for the Society to show the necessary degree of financial strength on its regulatory returns. The PO has found that the regulators were mal-administrative in failing to identify the devices used to conceal that weakness from public knowledge. This failure was not just an isolated incident, but as the PO's report shows, continued for a decade.

- 35 The initial regulatory failure enabled the Society to carry on expanding its with profit business based upon imprudent bonuses and a fictitious marketing track record. The regulators carried on failing to deal properly with the Society's Returns in the following years, during which time its size expanded six fold from £5 billion to £30 billion. During this time it drew in 500,000 individual and one million group investors, mostly people saving for their retirement.
- 36 The regulators cannot reasonably claim that they didn't know what was going on. Both Lord Penrose and the PO demonstrate that they were well aware that bonuses were too high and the Society had insufficient assets to support them. They had opportunity after opportunity to take a stronger line but failed to do so. In EMAG's view, the Treasury and the FSA's approval of the worthless financial reinsurance contract as an asset valued at £800 - £1,000 million amounted to connivance with Equitable Life to cover up its appalling financial state.
- 37 In EMAG's view, supported by Counsel, the thousands of millions of pounds involved, the time over which the fault was allowed to continue, their connivance with the cover up and subsequent delaying action require that the regulators should bear a heavy percentage of the blame and an appropriate discount is 10%.

#### Interest

- 38 The PO in her publication 'Principles for Remedy' requires simple interest to be added at a reasonable rate to the date of payment. EMAG believes that because of the nature of the loss, the amounts involved and the long Treasury inspired delay, compound interest would be more appropriate. We suggest a rate of 5%.

#### Computation of Loss and Cost to the Public Purse

- 39 Below is our outline computation of the losses incurred and the cost to the public purse:

		£m
Relative Loss		4,800
Loss Mitigation Costs		<u>1,050</u>
Policyholders losses to 2001		5,850
Less: Discount for those who would not have invested in / moved to another provider, even if they had known Equitable Life's true state and for the chance that the alternative provider could have done even more badly	37%	<u>2,165</u>
		3,685
Less: Discount for the fact that Roy Ranson and the Directors were primarily responsible. However the regulators allowed a problem with a small company to escalate six-fold over a decade, then adopted cover-up and delay.	10%	369
		<u>3,316</u>
Compound Interest at say 5%	7 years	<u>1,350</u>
Cost to the Public Purse		<u><u>4,666</u></u>

- 40 Interest should continue to accrue until payment. Administration and distribution costs should be borne by the Treasury, not the compensation fund. 90% of Equitable Life's business related to pensions. In due course such compensation will manifest itself as additional pension income, from which the public purse will recover income tax, and save tax credit payments to those policyholders who would otherwise be in poverty.
- 41 We stress that this is a simplified outline. There are special cases, particularly those of late contributors and with profit annuitants, which require investigation. They represent about 13% and 14% of 2001 policy values respectively. Furthermore it is derived from public information and using reasonable estimates. It could undoubtedly be improved and refined with access to Equitable Life and FSA information, which MPs could request to be made available.

#### **Distribution - 'NO CLAIMS' Basis**

- 42 It would greatly simplify and accelerate distribution if Parliament ordered that the aggregate amount of compensation, which it thought appropriate, should be paid to the proposed Compensation Tribunal. This would be a fixed sum which would then not balloon out of control. The tribunal would then be responsible for effecting distribution amongst policyholders. The cost of the exercise would be borne by the Treasury.
- 43 The categorisation and calculation of policyholders and the amounts payable to each could be done based upon the information existing on Equitable Life's computers. In view of the substantial age of the individuals, the fact that many have died, and the long delays that have already occurred, it would be quite wrong to require policyholders to submit claims. Most would be unable to complete a claim form document and would have to employ financial consultants. We do not want this exercise to present a windfall for such advisers and unduly prolong the payment of compensation.

#### **Recipients and Tax**

- 44 As regards compensation payments in cash to individuals or their beneficiaries, we recommend that some notional tax be deducted on an average basis and that the resulting compensation be made tax free. Elderly and much wronged Equitable Life policyholders should not be burdened with future battles with HM Revenue & Customs.

#### **LORD PENROSE AND THE PARLIAMENTARY OMBUDSMAN**

- 45 Lord Penrose, whose report was published in 2004, found that 'principally, the Society was author of its own misfortunes'. However he also concluded that 'the standards of scrutiny [by the regulators] still impress me as complacent, lacking challenge, and hesitant in criticism and in following up on any criticism made'. In short, he reported that the regulators knew what was going on, but took no effective action.

46 The PO's function was very different from that of Lord Penrose. Her job was to scrutinise the activities of the regulators, decide whether they were guilty of maladministration, to decide whether this maladministration led to injustice and to recommend redress. Her focus was on the regulators, whereas Lord Penrose's was mostly on the directors. One area of common interest was Equitable Life's use and the regulators condoning of 'practices of dubious actuarial merit'. Given the differences in objective, scope and focus between the two investigations, we find them to be remarkably compatible.

**Equitable Members' Action Group**

**4 Nov 2008**

A more detailed examination of the issues is available on EMAG's web-site <http://www.emag.org.uk/documents/EMAGsubmissionPO2.PDF>

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## APPENDIX A

### EQUITABLE LIFE / AVERAGE FUND COMPARISON

£10,000 Invested 1 Jan	1990 £	1991 £	1992 £	1993 £	1994 £	1995 £	1996 £	1997 £	1998 £	1999 £	2000 £
<b>Contractual Exit 1 Jan</b>											
<b>Money Management -</b>											
<b>Average Fund</b>											
2000	<b>29,567</b>	26,212	23,299	20,766	18,557	<b>16,628</b>					
2001	34,425	<b>29,956</b>	26,503	23,515	20,922	18,668	<b>16,704</b>	14,116	12,597	11,449	10,600
2002	36,339	31,843	<b>28,027</b>	24,465	21,510	19,049	16,993	<b>15,270</b>	13,108	11,910	11,025
<b>Equitable Life</b>											
2000	27,447	24,506	21,881	19,892	17,603	16,003	14,548	13,226	11,704	10,640	9,500
2001	23,816	21,265	18,986	17,260	15,275	13,886	12,624	11,568	10,851	10,329	9,833
2002	24,293	21,690	19,366	17,606	15,580	14,164	12,887	11,973	11,231	10,691	10,177
<b>Relative Loss</b>											
2000	2,120	1,705	1,419	874	954	625					
2001	10,609	8,692	7,517	6,254	5,647	4,782	4,080	2,548	1,746	1,120	768
2002	12,046	10,153	8,661	6,860	5,930	4,886	4,106	3,298	1,877	1,219	848