



Our ref: 44420.7 SEG  
Date: 13 March 2009

Direct fax: +44 (0)20 7833 7861  
Direct email: [s.grosz@bindmans.com](mailto:s.grosz@bindmans.com)  
PA: [c.jennings@bindmans.com](mailto:c.jennings@bindmans.com)

The Rt Hon Ian Pearson MP  
Economic Secretary  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Also by email: [ian.pearson@hm-treasury.gsi.gov.uk](mailto:ian.pearson@hm-treasury.gsi.gov.uk); [ministers@hm-treasury.gsi.gov.uk](mailto:ministers@hm-treasury.gsi.gov.uk); [rhys.maynard@hm-treasury.x.gsi.gov.uk](mailto:rhys.maynard@hm-treasury.x.gsi.gov.uk)

Dear Sir

## Equitable Life: a decade of regulatory failure

1. We have been consulted by the Equitable Members Action Group Limited (EMAG) about the Government's response (the Response) to the report of the Parliamentary Ombudsman's Investigation into the prudential regulation of the Equitable Life Assurance Society. The response is contained in Cm 7538, which was published on 15 January 2009. This letter is written in accordance with the Pre-Action Protocol for Judicial Review claims. The letter includes substantial citation from the documentation so that it may be read as a self-contained document.
2. References to the Ombudsman's report in this letter are references to Part One, the main report, unless otherwise stated.

### EMAG

3. EMAG was formed as an unincorporated association days after the ruling of the House of Lords on 20 July 2000. It is now a company limited by guarantee comprising approximately 21,000 present and past Equitable policyholders. Its objects are to further the interests of members and former members of Equitable, and those having or formerly having had interests in its with-profits policies. It has been closely involved in the Ombudsman's investigation throughout all its stages. EMAG will be the claimant in any claim for judicial review which may be brought. We assume, but kindly confirm, that the Treasury will not raise any issue as to EMAG's standing to bring this claim.

**CONSULTANT**  
Sir Geoffrey Bindman

**PARTNERS**  
Tamsin Allen  
Alison Burt  
Saimo Chahal  
Jon Crocker  
Katherine Gieve  
Stephen Grosz  
John Halford  
Lynn Knowles  
Neil O'May  
Shah Qureshi  
Michael Schwarz  
Alison Stanley  
Julia Thackray

**ASSOCIATES**  
Liz Barratt  
Louise Coubrough  
Liz Dronfield  
Mark Emery  
Rhona Friedman  
Kate Goold  
Siobhan Kelly  
Jude Lanchin  
Alla Murphy  
Martin Rackstraw  
Paul Ridge  
Katie Wheatley

**EMPLOYED BARRISTER**  
Neil McInnes

**SOLICITORS**  
Emilie Cole  
Chez Cotton  
Rosalind Fitzgerald  
Charlotte Haworth-Hird  
Laura Higgs  
Catherine Jackson  
Saadia Khan  
Shazia Khan  
Sara Lomri  
Gwendolen Morgan  
Pratik Patel  
Najma Rasul  
Jessica Skinns  
Emma Webster

**CONSULTANTS**  
Madeleine Colvin  
Philip Leach  
Emma Norton  
David Thomas

**CHIEF EXECUTIVE**  
Nick Martin

*Specialist  
Fraud Panel*



*Community  
Legal Service*



Regulated by the  
Solicitors  
Regulation  
Authority

## Bindmans LLP

275 Gray's Inn Road London WC1X 8QB  
DX 37904 King's Cross Telephone 020 7833 4433 Fax 020 7837 9792  
[www.bindmans.com](http://www.bindmans.com) [info@bindmans.com](mailto:info@bindmans.com)

Bindmans LLP is a limited liability partnership registered in England and Wales under number OC335189. Its registered office is as set out above. The term partner means either a member of the LLP or a person with equivalent status and qualification.

## General considerations

### *Reasons for rejecting the Ombudsman's findings - the test*

4. In the Response, the Government rejects, in whole or in part, a substantial number of the findings contained in the Ombudsman's report and her recommendations as to remedy. In other cases, its acceptance of findings of maladministration or injustice is qualified by its "observations" or "explanations" as to the basis of its acceptance. To the extent that these qualifications depart from or dilute the full extent of the Ombudsman's findings, they must be regarded as rejection and the reasons supporting them must meet the same test. These qualifications are significant, since Sir John Chadwick is required to give his advice on the basis of them: his Terms of Reference require him to "[a]ccept as correct and be able to consider all of the Ombudsman's findings of both maladministration and injustice in so far as those findings are accepted by the Government" (Response page 45, emphasis added).
5. The Court of Appeal in *R (Bradley and others) v Secretary of State for Work and Pensions* [2008] 3 WLR 1059 laid down the circumstances in which a Minister is entitled to reject an Ombudsman's conclusions:
 

"...the Secretary of State, acting rationally, is entitled to reject a finding of maladministration and prefer his own view. But, as I shall explain, it is not enough that the Secretary of State has reached his own view on rational grounds: it is necessary that his decision to reject the Ombudsman's findings in favour of his own view is, itself, not irrational having regard to the legislative intention which underlies 1967 Act. To put the point another way, it is not enough for a Minister who decides to reject the Ombudsman's finding of maladministration simply to assert that he had a choice: he must have a reason for rejecting a finding which the Ombudsman has made after an investigation under the powers conferred by the Act." [51]

"The question is not whether the defendant himself considers that there was maladministration, but whether in the circumstances his rejection of the Ombudsman's finding to this effect is based on cogent reasons." [72]

"I am not persuaded that the Secretary of State was entitled to reject the Ombudsman's finding merely because he preferred another view which could not be characterised as irrational. As I have said, earlier in this judgment, it is not enough that the Secretary of State has reached his own view on rational grounds: it is necessary that his decision to reject the Ombudsman's findings in favour of his own view is, itself, not irrational having regard to the legislative intention which underlies 1967 Act: he must have a reason (other than simply a preference for his own view) for rejecting a finding which the Ombudsman has made after an investigation under the powers conferred by the Act." [91]
6. In the following paragraphs we set out factors which are relevant when considering whether the test of cogency is satisfied.

---

**A. *The relevance of the adjudicative process***

7. In determining whether the decision to reject a finding is irrational the court will have regard to the circumstances in which, and the statutory scheme within which, the finding of fact was made by the adjudicative body ([70]). Accordingly, account must be taken of the nature of the investigation which the Ombudsman has undertaken, the opportunities afforded to the Government to make representations to her and the steps which she has taken to take account of those representations.
  - i. subject matter*
8. The Ombudsman's report deals with a complex area of regulation, and it is the fruit of careful and lengthy investigation. As she makes clear in the opening words of the foreword to the report, it is now the most complex, lengthy and demanding investigation that her office has ever undertaken.
  - ii. opportunity to make representations*
9. The Ombudsman afforded the public bodies which were the subject of the investigation a number of opportunities to make representations to her, both before the investigation took place (see paragraph [14] of Chapter 3) and during its course. Details are set out in the Ombudsman's outline description of her investigation in paragraphs [29] - [66] of Chapter 3. It is to be noted in particular that the public bodies made observations (with references to paragraphs in Chapter 3):
  - a. in March 2005 in response to the heads of complaint ([31]);
  - b. in July 2005 on the detailed submissions by the action groups ([45]);
  - c. in July and November 2005 on the Ombudsman's discussion document ([48]);
  - d. after September 2005, January 2006 and December 2006 on the drafts of parts 2 and 3 of the report ([50]);
  - e. in April and September 2007, on the first draft of part 1 of the report ([57 & 59]). The Ombudsman reviewed her draft report in the light of those observations and communicated the result of that review to the public bodies on 30 November 2007 ([60]);
  - f. after February 2008, in response to the revised draft report ([63]).
10. The Ombudsman's report sets out at length the observations which the public bodies made and her evaluation of them. It is clear that she considered those observations carefully and made very substantial revisions to her draft report in the light of them. In those circumstances, it is not enough for the body concerned, when rejecting her findings, simply to repeat its own reasoning without addressing the Ombudsman's reasons for rejecting it. In adopting such a course, the body concerned fails to answer an important element in the Ombudsman's reasons for reaching her conclusions.

*iii. professional advice*

11. The Ombudsman's findings, including her evaluation of the public bodies' representations, have been made after taking detailed professional advice. The Ombudsman arranged for her actuarial advice to be peer reviewed (paragraph [36] of Chapter 3). In March 2007, the full draft of the provisional report of her actuarial adviser was made available to the public bodies ([56]). In the light of the representations received from the public bodies in April 2007, she conducted a fundamental review of the first draft report. She sought further advice and the views of peer reviewers ([58]).
12. The Ombudsman shared with the public bodies and other interested parties the actuarial advice which she received. You have confirmed that the Treasury did take external actuarial advice in reaching its decision to reject part of the Ombudsman's findings. You have declined to disclose that advice to us, for the following reason:

“We believe that the reasons for the Government's decisions have been clearly set out in its response, to an appropriate degree. Any person wishing to consider whether the conclusions reached are ones lawfully open to the Government are [sic] able to do so.” (Treasury letter of 19 February 2009)
13. In our opinion, this is not acceptable. Where the Government rejects a finding in a complex area such as this, in particular where it has had access to the Ombudsman's own detailed professional advice, it is not enough simply for the Government to make assertions as to the advice it has received, or to summarise the conclusions contained in that advice. This does not allow the reader to assess the cogency of the Government's reasons for preferring its own advice in what is a complex area: it is impossible to tell whether the underlying advice supports the asserted conclusions on which the Government relies, and the extent to which it may have been qualified. In particular, it is impossible to tell whether the Government has been advised that the Ombudsman's conclusions are (a) untenable or (b) within the range of reasonable judgments of a professional acting with the skill and care that could reasonably be expected.
14. Moreover, given the careful process adopted by the Ombudsman in arriving at her conclusions, it will be relevant to know whether the Government has sought advice from more than one source and, in any event, the sources of the advice received. The Government is aware of the quality of the advice which the Ombudsman has received, as are our clients. Those considering the response do not know whether the Government's advice was independent and disinterested.
15. **We therefore repeat our request that the Treasury disclose the professional advice it has received. When replying, kindly let us know whether the Treasury sought advice from more than one source and, if so, whether the various sources of advice concurred in the views which are summarised in the Government's response. Kindly also identify the sources of**

advice. Please treat these requests as also made under the Freedom of Information Act 2000.

***B. The standard of regulation***

16. The Ombudsman concluded (Chapter 13 at [176]-[177]):

I consider that this serial regulatory failure, which the maladministration I have found in respect of the period prior to the Society's closure to new business represented, has caused further injustice to those who have complained to me. ... Such injustice takes the form of a justifiable sense of outrage that those operating the system of prudential regulation so comprehensively failed...

17. The Response ([3.5]) indicates that the actions of the regulator fell to be considered in the context of the regulatory regime as it stood at the time. This the Government described as "reactive and unintrusive" and placing considerable reliance on the Appointed Actuary. In particular, the response noted that the regulator "was not required to second-guess those commercial decisions which were properly for the boards of insurance companies" (Response [1.12]). In a number of instances, the Response has concentrated on the narrow question whether the returns complied with the relevant regulations and whether the Society was solvent in order to conclude that any maladministration by the regulator would not have made any material difference to the content of the returns. The basic premise underlying the Response seems to be that, if there was no specific regulation to deal with an individual point, or if the regulation which existed was in any way deficient, the regulator could be excused for doing nothing. On this basis the Government has rejected many of the Ombudsman's findings of injustice or maladministration. For example,

- a. in relation to valuation interest rates and consequent affordability and sustainability of bonus declarations, the Response argues that the regulator could not have enforced an increase in liabilities (or prevented a bonus declaration) because the relevant regulations did not entitle them to do so;
- b. the Response asserts that no regulation was breached when the differential terminal bonus policy was introduced and, in consequence, regulators could do nothing about the policy, which was clearly intended to pass liability from the Society to individual policyholders.

18. In her first Memorandum to the Public Administration Select Committee (PASC) submitted in January 2009 the Ombudsman said:

I addressed [the public bodies'] more limited assertions about the nature of the regulatory regime in Chapter 9 of Part 1 of my report.

The principal basis for the Government's view seems to be such an assertion - that the regime was 'reactive and unintrusive'. Many of the subsequent rejections of my findings appear to be based on this inadequate view as to what the duties and powers of the prudential regulators at the time were.

---

The Government's response is partial - making, for example, no mention of the EC Directives in which that regime was grounded - and is not evidenced - failing to provide any support for the Government's limited view. ([30], first bullet point).

19. The Ombudsman conducted a detailed study of the powers of the regulators (see Part 2 of her report). Her assessment is grounded in the statutory provisions and in non-statutory guidance, and consideration of the regime in practice. In making her findings, the Ombudsman considered the submissions made to her by the public bodies on the matter and Chapter 9 sets out her assessment of them. The Response does not indicate that the Government rejects the Ombudsman's findings as to the nature of the regulatory regime; nor does it set out any reasons for disagreeing with the conclusions that the Ombudsman has reached in that part of her report. We consider, therefore, that the Government is not entitled, without more, to reject those findings, or to reject findings of maladministration or injustice, on the basis of its own more limited view of the regulatory regime. See, for example, [4.26] of the Response, considered at paragraph 59 below.
20. In practice, the regulator's power was not so restricted. It will be recalled that section 45(1) of the Insurance Companies Act 1982 conferred on the Secretary of State a general power to require a company to "take such action as appears to him to be appropriate for the purpose of protecting policy holders or potential policy holders of the company against the risk that the company may be unable to meet its liabilities or, in the case of long term business, to fulfil the reasonable expectations of policy holders or potential policy holders". That broad power was not limited to cases where there has been a breach of the solvency provisions or a failure to calculate the company's liabilities in accordance with the valuation regulations, as is clear from section 45(2). Moreover, section 45(1) was extended by the Insurance Companies (Third Insurance Directives) Regulations 1994 by giving the Secretary of State an additional power to require a company to take action to ensure fulfilment of sound and prudent management criteria and to make changes in relation to restrictions on the free disposal of assets.
21. If, as the Ombudsman has found and the Government has accepted, the regulators' failure to identify the problems at Equitable Life amounted to maladministration, it would appear to follow that a soundly based and properly conducted programme of prudential regulation would have brought those problems to light. That having happened, it is unrealistic to assume that the regulators could or would simply have stood by, unable to do anything about the matter. The evidence presented by the Government to Lord Penrose strongly suggests that this is not what would have happened: the Treasury memorandum at Appendix 4 to a document headed "Supplementary Memorandum from HM Treasury: Answers to Treasury Committee Questions on pension-mis-selling" explained that section 45 had been used on a variety of occasions and for a variety of particular purposes, including, for example, to prevent a company from paying a dividend. Significantly, paragraph 7 of that memorandum stated

that “the effect of section 45 is far greater than the formal exercise of the power suggests”.

22. The Government’s more limited approach to regulation was considered by Lord Penrose in his report. In Chapter 15 he considered the argument that:

As long as a company remained solvent, and there were no statutory concerns over the returns that it was making, such a requirement could not have been imposed on a company while it remained open to new business.

23. Having considered the arguments advanced to him in support of this more limited view of regulation he concluded at [19]:

In summary, in certain limited circumstances there is some substance in the point, but it does not support the general argument that regulators could not have intervened on PRE grounds to require recognition of accrued terminal bonus to some degree that reflected the Board’s expectations of future market movements, qualified by a good dose of prudence. If it had, the whole provisions relating to PRE could have been reduced to an emasculated section 45. I should add that after these arguments had been considered and dealt with I received additional representations from the Treasury that recognised some of the points made above.

24. The broader view of the purpose of regulation is also supported by the conclusions of the Report of the Committee of Inquiry into the crisis of the Equitable Life Assurance Society established by the European Parliament (EQUI) (see paragraphs 5, 7 and 10 of EQUI’s conclusions set out at paragraph 35 below). We note that the Response appears to have taken no account of these conclusions, which are not mentioned at all.

25. We will deal with these matters further when considering the Government’s response to individual findings. However, the consequence of the Government’s approach appears to be as follows:

- a. For the return years from 1990 to 1995 inclusive, the Society’s actuaries sought to discount heavily its liability in respect of its mainstream pension business by something like one half of the aggregate guaranteed policy values reported to policyholders. It was clear to Government Actuary’s Department (GAD) and the regulator from the information available to them that this fell a long way short of the prudent approach to the valuation of liabilities intended by those who framed the regulations and the actuarial guidance. The Response asserts that the regulators could not have enforced an increased valuation of the liabilities;
- b. In the 1993 Return, Equitable Life’s method of dealing with the guaranteed annuity rate (GAR) problem - the introduction of a differential terminal bonus policy - was revealed to the regulators. This change of policy was intended to pass this substantial and growing liability from the Society to individual policyholders, without telling those policyholders what it was doing. The very fact that the policy change was made in secret transgressed the basic principles under which business should have been conducted. Although that was a matter for the

- conduct of business regulator, it also affected policyholders' reasonable expectations and was therefore a matter for the prudential regulator. Furthermore, any investigation would have revealed Equitable Life's huge exposure to the GAR risk and the fact that it had made no provision whatsoever for that risk in its regulatory returns. This was very much a matter for the prudential regulators. The Response asserts that the regulator could have done nothing about the change of policy because Equitable Life was in breach of no specific regulations;
- c. In 1995 the regulators identified that Standard and Poor's rating of Equitable Life as 'AA (Excellent)', when it was nothing of the sort, was derived from the misleading way in which the Society presented its calculations. It must have been a matter of concern to the prudential regulators that existing and new investors in Equitable Life were being seriously misled by this erroneous rating. The Response asserts that there was no regulatory requirement on the Society to include the amount of its resilience reserve in its returns, that the regulator and GAD had no duty to rectify any perceived inaccuracies or misunderstandings on their part of the agencies; and indeed that they were entitled to carry on using the erroneous rating for their own internal purposes, for briefing Ministers and for answering questions;
  - d. For 1998 the FSA allowed Equitable Life to claim as an asset worth £800m a financial re-insurance agreement, which was not in force at the year end, which had cost it only £150,000, which GAD had said was not sufficient for the purpose and which the Parliamentary Ombudsman found to be worthless. The contemporary consensus view of both the regulator and the Society was that without such a credit, Equitable Life could not have declared a bonus for that year and that would have amounted to commercial suicide. The Response now claims that, had the £800m credit been disallowed, Equitable Life would have sought other ways of increasing its assets or reducing its liabilities in a manner which, it is to be assumed, could not have been successfully challenged by the regulator.

### ***C. Loss of opportunities***

- 26. At various points, the Ombudsman's report finds that the maladministration which she has found caused injustice in the form of a justifiable sense of outrage, financial loss and loss of opportunities. In the Response, the Government has sought to meet several of the Ombudsman's findings of injustice by asserting that since the relevant returns complied with the applicable regulations, the outcome would not have been different if there had been no maladministration. The Ombudsman has observed that the Government's rejection of her findings has no basis, since it proceeds from a misunderstanding of the regulations and of EU law which underlies them. This view is supported by EQUI. Moreover, as the Ombudsman points out, the Response does not meet her findings that investors lost opportunities to make other decisions.

27. As well as identifying lost opportunities in relation to a number of her specific findings, the Ombudsman found as a general consequence that the published returns were unreliable. At paragraph [61] ff of Chapter 12 of her report, she says the following:

61 By saying that the regulatory returns were unreliable, I do not in every case suggest that the Society's returns would have been found to be deficient had appropriate questioning by the prudential regulators and/or GAD taken place. However, the prudential regulators, acting with advice and assistance from GAD, had not verified that those returns were complete, accurate and in compliance with the requirements of the law. Those regulators could thus not have been satisfied that the Society's returns showed its true financial position and were thus reliable.

62 Those published returns materially understated the Society's liabilities in several respects. That would have misled those seeking to assess the financial strength of the Society by considering those returns. Information in the returns was misleading and would have led those reading them to assume that the Society's financial position was stronger than the position reported in the returns, when that was not the case.

63 Anyone investing in the Society - whether as a new investor or as someone making a further investment in it - from the second half of 1991 onwards was at risk of being misled, if they had regard to the regulatory returns, about the financial condition of the Society. The prudential regulators permitted returns to be published which those regulators could not have been satisfied revealed the Society's true liabilities or an accurate financial position.

28. The Ombudsman further explained why she addressed compendiously the consequences of the findings which relate to the content of the Society's returns in the period prior to 20 June 1998:

84 I take that approach because I consider that specific elements of the content of the returns cannot be addressed in isolation from each other. The users of those returns would be looking at the financial condition of the Society (or any other insurance company) as published within the returns as a whole.

85 Such a user would be entitled to assume that the published returns were accurate, complete, in compliance with the regulatory requirements, and not misleading. This assumption would be based on a belief - encouraged by the nature of the concept of 'freedom with publicity' - that the returns as a whole were not misleading and set out the true position.

29. The Ombudsman concluded that the maladministration found led to lost opportunities in a number of specific cases (the references in brackets are to Chapter 9 of the Ombudsman's report):

- a. Lost opportunity to take an informed decision due to the unreliability of the of the information contained in the Society's returns for 1990 to 1996 ([100]);
- b. Loss of opportunities to take informed decisions about financial affairs from July 1994 to April 1999 in full knowledge of the

Society's exposure to the GAR risk because of failure to follow up the differential terminal bonus policy ([121]);

- c. Lost opportunities to take informed decisions about financial affairs because of misinformation about the financial reinsurance treaty ([146]);
- d. Lost opportunities arising out of the information provided by the regulators after closure ([168]).

30. In her first Memorandum to PASC, the Ombudsman said:

... the Government's response has provided no basis that reasonably could question the undeniable fact that maladministration led to the loss of opportunities that are set out in some detail in Chapter 12 of Part 1 of my report, instead addressing findings - that injustice is predicated only on a particular outcome transpiring - that I have not made. Injustice in the form of the lost opportunities has thus not properly been addressed. ([30], second bullet point)

31. As the Ombudsman made clear, the matter is particularly pertinent in relation to her finding of injustice in relation to the unreliability of the returns due to inadequate scrutiny. In her second Memorandum to PASC (dated 9 February 2009), she said:

8. Throughout the Government's response to my findings in relation to the scrutiny by GAD of those returns, it is asserted that my findings of injustice consequent on those of maladministration can be rejected now because the relevant maladministration, in the Government's view expressed some years later, would not *'have resulted in any changes to the contents of Equitable Life's regulatory returns in the relevant years'*. [See, for example, paragraphs 4.35, 4.39, 4.43, 4.46, and 4.99 of the Government's response].

9. Leaving aside the fact that no sufficient evidence is provided for such assertions, such a rejection does not address the basis on which my findings of injustice resulting from maladministration in the scrutiny of the contents of the relevant returns were made.

10. The consequences of the various failures of GAD in respect of their scrutiny of the Society's regulatory returns during the relevant period were that those returns, as published following such scrutiny, were **unreliable**. In that context, I found injustice in the form of **lost opportunities** on the part of existing and potential policyholders to make informed decisions about important financial matters.

11. The Government's response has not addressed the issue of those lost opportunities, nor has it explained how - even if the doubts expressed in my report can much later be proved groundless - a finding that the relevant regulatory returns were not reliable can be rejected.

12. By focusing on whether those returns would necessarily have been different, the Government has failed to address the basis - a lost opportunity - on which I criticised those responsible for the scrutiny of those returns.

32. The Ombudsman's finding was that policyholders making investment decisions were entitled to believe that they could depend on returns

as a reliable guide to the company's health. The reason was that they were entitled to believe that they were the product of rigorous and conscientious regulatory scrutiny, whereas in fact (as the Ombudsman has found and the Government has accepted) that was not the case. That is the burden of paragraphs [84] and [85] quoted in paragraph 28 above. In rejecting the Ombudsman's findings of injustice, the Government has quite simply failed to address the Ombudsman's findings and conclusions as to loss of opportunity in this respect.

***D. Failure to take account of the Report of the Committee of Inquiry established by the European Parliament (EQUI)***

33. The Ombudsman found that the Government had failed properly to implement in the case of Equitable Life the system of regulation that Parliament had enacted, in part to deliver the protection of policyholders that the European Directives imposed.
34. EQUI received and considered a very substantial body of evidence, including evidence from the Treasury, the FSA and GAD. Its conclusions as to compliance with European law during the relevant period, and its recommendations, are clearly relevant considerations which the Government must take into account when deciding how to deal with losses caused to policyholders.
35. EQUI adopted its report on 23 May 2007. It was subsequently debated and accepted with an overwhelming majority at the Parliament's plenary session on 19th June 2007. EQUI found considerable shortcomings in the transposition and implementation of European Directives relating to the regulation of life assurance companies. By way of example, EQUI reached the following conclusions (starting on page 117 of the report) which are relevant:

*General matters relating to the standard of regulation*

5. The committee is of the opinion that the application of the 3LD [the Third Life Directive] by the UK in respect of the ELAS case was deficient and that UK regulators and authorities did not adequately respect the ultimate purpose of the Directive. The committee believes that, in the present case, the combination of a formalistic transposition with an application which was defective in several respects leads to the conclusion that the implementation process as a whole was flawed.

7. The committee believes that UK authorities' supervision of ELAS disregarded or misinterpreted the concept of "financial supervision of the entire business" contrary to Articles 82, 18 3 and 25 4 of the 3LD.

10. It is also apparent that the UK regulators behaved with undue awe or deference towards ELAS, particularly given its long history and hitherto highly reputable status, leading them to consider it as the top pick of the life insurance industry and apparently believed to be too good and too reputable to make mistakes. [At page 201]

*Matters relating to the evaluation of liabilities in regulatory returns*

8. The committee believes that the option contained in paragraph 1.D of Article 18 of the 3LD does not exclude future discretionary or non-

contractual bonuses from being an integral part of the company's 'entire business' and does not exonerate Member State authorities from doing their utmost to respect the letter and the aim of the Directive. Furthermore, it appears from the material available to the committee that one of the main reasons for ELAS' financial downfall was the fact that, throughout the years, it did not properly reserve for future discretionary or non-contractual bonuses.

10. Submissions made to the committee suggest that the regulator tended to focus on solvency margins in a narrow sense and took little or no account of future discretionary and non-contractual bonuses in its overall analysis of the financial health of the company. The committee believes therefore that it is likely that the regulator did not manage to guarantee that ELAS had an adequate solvency margin in respect of its entire business at all times.

12. According to some statements made to the committee, the concept of PRE included the fact that policyholders expected to receive discretionary bonuses in addition to contractual benefits. If UK authorities were obliged to respect PRE as part of their obligations under Community law, the committee considers that they should have also made sure that reserves covered discretionary bonuses. The committee believes that, by not considering discretionary bonuses as an integral part of the company's entire business and not obliging ELAS to provide adequate technical provisions for them, the UK regulators did not pay due regard to PRE and thereby appear to have breached the letter and aim of Article 18 of the 3LD.

*The GAR risk (page 201)*

8. There is a large body of material which suggests that the UK regulators failed to recognize - or even negligently underestimated - the potential impact of GAR policies on the financial stability of ELAS, particularly in the event of a substantial downturn in financial markets and given ELAS' reputation of applying thin solvency and reserve margins. It seems that when this risk was finally recognized by UK Regulators, it was too late to reverse the situation and any subsequent regulatory action could only be a belated attempt at damage limitation.

*Remedy*

36. EQUI made the following recommendation:

It is one of the major objectives of the Third Life Directive to ensure "*adequate protection*" of policyholders through rigorous supervision. As was shown in Parts II and III of this report, the UK regulators failed in a number of respects to supervise and monitor the financial health of Equitable Life, including its state of solvency, the establishment of adequate technical provisions and the covering of those provisions by matching assets, according to the requirements laid down in the Third Life Directive. Had the UK regulators correctly applied the provisions of the Directive, they would most likely have achieved its objective to 'ensure adequate protection of policyholders' and thus have avoided the crisis at Equitable Life, which caused substantial losses to policyholders.

...

In light of the above, the committee considers it appropriate to recommend strongly to the UK Government to devise an appropriate scheme with a view to provide full compensation for Equitable Life victims both within the UK and abroad for its failure to protect

policyholders in accordance with EU legislation. In the absence of viable alternatives, the committee sees it as an obligation of the UK Government to assume responsibility for its failures and provide redress for citizens' grievances. The committee believes that this must happen now, in order to put an end to this affair and secure relief for the many victims.

37. In our letter of 23 January 2009, we asked for copies of any documentation which showed that the Government took the Report into account when considering its response to the Ombudsman. None has been provided. In your letter of 19 February, you told us that the Treasury "was mindful of the European Parliament's Committee of Inquiry Report, which was itself discussed within the Report produced by the Parliamentary Ombudsman, when considering its response to the Ombudsman's report".
38. The Government has undertaken to the European Parliament, and the UK Parliament, that it will consider and respond to the report. To date the Government has not published a response, nor are its conclusions and recommendations mentioned, let alone addressed, in the Response. There is no evidence, beyond the assertion in your letter, that the Treasury took any account of the evidence and conclusions in the EQUI report in deciding how to respond to the Ombudsman's report and how to treat those who have suffered loss as a result of failures of regulation.
39. Absent any evidence to the contrary, it appears to us that the Government has failed to take account of the EQUI report in reaching its conclusions on how to deal with the Equitable affair.

#### **BACKGROUND TO THE FINANCIAL ISSUES**

40. Before looking at the Government's rejection of individual findings, it is necessary to set matters in context. The following brief description of Equitable Life's recent financial history is derived from (a) EMAG's initial response to the Ombudsman's report (prepared by Chartered Accountants Burgess Hodgson) dated 16 July 2008 (a short extract from which is attached as Annex A); and (b) EMAG's Memorandum on the Government's response to the Ombudsman's report (prepared by Burgess Hodgson) which was submitted to the Public Administration Select Committee on 26 January 2009 (which is attached as Annex B).
41. The Equitable Life Assurance Society is the world's oldest life assurance company. The Government Actuary recommended it for public servants including health workers and judges as suitable for additional pension investment. However, during the 1980s and 1990s, under the stewardship of its actuary Roy Ranson it:
  - a. made no provision for the guarantees against low interest rates contained in all policies issued before 1988 (the guaranteed annuity rate or GAR).
  - b. declared bonuses out of all proportion to profits and assets. Lord Penrose estimated that the cost in excess bonuses paid out to retiring policyholders in the 1990s was £1,800 million.

42. The Society's attempt to dishonour its GAR obligations failed in the House of Lords in July 2000 at an estimated cost of £1,500 million. But the Society had been so weakened by over-bonusing that it could not pay. Indeed it was so weak that no-one would buy its with-profit business at any price. It closed to new business in December 2000 and its directors resigned.
43. The regulatory regime created by the Financial Services Act 1986 placed considerable emphasis upon financial advisers justifying their choice of company. This in turn provided a substantial competitive advantage to companies which could show an impressive track record of past performance. For with-profit companies, this entailed voting the maximum bonuses.
44. In the late 1980s and early 1990s the Society's bonuses were raised to such a level that its assets fell short of the aggregate policy values which it had indicated to policyholders (its liabilities) by a margin of about 25-30% (Annex A, Chart 1). The bonuses voted for 1990, combined with a falling stock market in that year, first created a substantial deficit of assets as compared to policy values; and that deficit ran consistently at about £1,000 million over the decade. During the same period the Society's with profit business increased six-fold in size (Annex A, Chart 2).
45. The stock market performed well over the decade and was still high when the Society closed to new business (Annex A, Chart 3). It was not the cause of Equitable Life's demise. Over the long bull market of the 1990s the Society should (by limiting bonuses) have built up a smoothing fund of surplus assets ready to meet the inevitable downturn. Instead inflated bonuses continued and the Society still had a deficit at the very peak of the market (FTSE-100 almost 7000 at December 1999), when there should have been a surplus.
46. In January 2007 a disciplinary panel of the Disciplinary Tribunal of the Institute of Actuaries expelled Roy Ranson from the Institute primarily because he had "consistently failed to apply an appropriate smoothing policy".<sup>1</sup> In layman's terms, he declared bonuses that meant that policy values exceeded assets for more than a decade.
47. In July 2001 the new board of directors cut policy values by 16% (about £4,000 million) and effected a compromise scheme to deal with the GAR problem. However Equitable Life's problems were too deep-seated and this was not enough to enable it to ride out the stock market falls of 2001/2002. In 2002 policy values were cut by another 10% and the Society was forced to invest almost exclusively in fixed interest stocks.
48. With almost none of its money invested in equity shares, the Society could not operate as a with-profit insurer and its policyholders did not benefit from the stock market's rise in 2003 to 2007. The Society is now being both run down and broken up.

---

<sup>1</sup> Executive summary of disciplinary proceedings against three former directors of the Equitable Life Assurance Society, issued by the Institute of Actuaries.

49. The effect of declaring bonuses without supporting assets was akin to a 'Ponzi scheme'. Such a scheme makes unjustifiably large payments to departing early joiners, with the intention of attracting new investors. Such new investors cannot possibly achieve the returns paid to early joiners, first because such returns are not commercially sustainable and secondly because premiums paid by later joiners are used to fund the excess costs of paying the early joiners. The Equitable Life carried on supporting excessive payments to outgoing early joiners and attracting substantial numbers of new joiners until it was forced to close to new business in December 2000.
50. The resulting 'winners' were those who left with unduly large policy proceeds in the late 1980s and during the 1990s. The 'losers' were those who joined during the 1990s, who bore the GAR costs and the cost of the excess bonuses paid to the 'winners', and whose own funds were cut in July 2001 and in 2002, and who possibly also suffered various exit charges.
51. The regulatory regime was intended to prevent the Ponzi type of scheme, by requiring each company to demonstrate on an annual basis that it had assets to cover its contractual liabilities by a significant margin. Even though non-contractual terminal or final bonuses were ignored in the 1990s, it was still difficult for the Society to demonstrate the required margin, precisely because aggregate policy values exceeded its assets by approximately 25 to 30%. Mr Ranson achieved this by what Lord Penrose described as "valuation practices of dubious actuarial merit" (Chapter 19, [240(5)], page 727).
52. Three such practices are the subject of the Ombudsman's findings. These are:
  - a. The rates of interest used by Mr Ranson to discount the Society's mainstream pension liabilities (representing about 80% of the fund) to something like half the guaranteed value reported to policyholders (findings 2 and 4).
  - b. Ignoring the liability for guaranteed annuity rates built into almost all pension policies issued up to 1988 (finding 3).
  - c. Claiming £800m - 1,000m credit for a worthless financial re-insurance policy (finding 6).
53. These matters are dealt with in more detail below.
54. We now turn to consider the Government's response to particular findings before considering the Government's proposed remedy. The fact that we do not deal with the Government's response to all the findings does not mean that our clients accept that the Government's position is lawful.

#### **INDIVIDUAL FINDINGS**

##### **Finding 1 - dual role of the Appointed Actuary and Chief Executive Officer**

55. The Government's reasons for rejecting the Ombudsman's finding of maladministration are essentially the same as those which the public

bodies addressed to her in the submissions which she sets out at [114] - [123] of Chapter 10. She was not persuaded by them, for the reasons which she sets out at [124] - [130] of that Chapter. We consider that those paragraphs contain a correct analysis of the position.

56. The Ombudsman has found that the Appointed Actuary was one of the cornerstones of prudential regulation. So much was also recognised by the public bodies in their submissions to the Ombudsman: see, for one example among many, the public bodies' submission recorded at [273] of Chapter 10:

GAD was entitled to rely on the Appointed Actuary to provide full and proper disclosure in the returns in accordance with his professional responsibility. The Appointed Actuary was a professional, subject to mandatory guidance and codes of conduct and accountable in that regard to the actuarial profession. GAD did not "police" Appointed Actuaries; that was not GAD's function and it was never intended that it be resourced or staffed to undertake any such task.

57. The regulators at the time recognised that, with Roy Ranson the Appointed Actuary holding the dual role of Appointed Actuary and Chief Executive, there was no one to blow the whistle on the Society should the need arise. As the Ombudsman pointed out in her report, the Society's rationale for the dual role - that there was no one within the Society of sufficient stature and with relevant experience to replace the incumbent Appointed Actuary - should have raised further concerns. In its decision of 30th January 2007 the Disciplinary Tribunal of the Institute of Actuaries described Mr Ranson as the dominant figure in the executive of the Society and a "powerful authoritarian", to whose advice there was no effective challenge. It also found that the Society employed almost no external financial advisers of any kind apart from their auditors but relied on the lack of comment from regulators and from the actuaries on the Board other than Mr Ranson.

58. Article 15.3 of the Third Life Directive provides that "the competent authorities of the home Member State shall require every assurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms". The Treasury's case, as put to EQUI, appears to have been that since the Directive does not mention the figure of the Appointed Actuary, this was not a matter for the Directive (see page 45, summarising the evidence of Mr Maxwell of HMT). However, EQUI concluded as follows (under the heading "Lack of sound administrative and accounting procedures and adequate internal control mechanisms"):

There are clear indications that the UK regulators knowingly failed to challenge the dual, and therefore conflicting, role of the Appointed Actuary of ELAS, who for six years also held a leading management post in the Society as its Chief Executive. The committee believes that this duality of roles created a conflict of interests detrimental to policyholders' interests which should have been challenged by regulators as an instance of bad corporate governance. Furthermore, the committee believes that, by not taking swift action on the issue of the double role of the Appointed Actuary, the UK regulator did not fulfil its obligation to require from ELAS "*sound administrative and accounting*

*procedures and adequate internal control mechanisms*" as required explicitly by the 3LD, and contrary to Article 8. The committee insists that the role of the Appointed Actuary was central to the UK supervisory system, and that a failure to guarantee the effectiveness of such a figure undermined the whole system of supervision, in particular rendering any internal controls completely inadequate. The committee considers that, once in place and irrespective of whether the concept was required under Community law, the Appointed Actuary became part of the UK regulatory and supervisory system which, as a whole, was subject to the 3LD. Furthermore, certain statements lead the committee to believe that this failure formed part of a wider administrative practice which undermined the effectiveness of the safeguards contained in Community legislation.

The Response does not meet this argument.

59. The Response also fails to provide an adequate basis for the assertion (at [4.26]) that "Any decision to conduct a more intensive scrutiny of Equitable Life on the grounds of the dual role would have been open to legal challenge by Equitable Life in the absence of statutory or regulatory justification." There can be no doubt that the regulator could have justified more intensive scrutiny on the basis of its existing powers, if necessary read in accordance with Community law, where the Appointed Actuary appeared to lack the independence necessary to carry out his task. We refer to paragraphs 16 ff above.
60. While the Ombudsman was unable to determine whether this maladministration caused injustice (because it involved making findings about persons or bodies outside her jurisdiction), it is nonetheless important given the extent to which other matters concerning the regulation of the Society rested on the independence of the Appointed Actuary (see, for example, [42] of Chapter 10 and [1.12] and [3.39] of the Response. See also [4.83], [4.88], [4.127] and [4.153]).
61. It is to be noted that on 30<sup>th</sup> January 2007 the Disciplinary Tribunal of the Institute of Actuaries expelled Mr Ranson from the Institute on grounds of misconduct, including his failure to ensure that the long term business of the Society was operated on sound financial lines.

#### **Findings 2 and 4 - scrutiny of the Society's returns.**

62. The Ombudsman found maladministration causing injustice in respect of scrutiny of the Society's returns for the period 1990 to 1993 and the period 1994 to 1996. In respect of both periods the maladministration included the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) the affordability and sustainability of the Society's bonus declarations.
63. Equitable Life's main line of business, representing about 80% of the with-profit fund, was the pension investment policy, that is, the accumulation of premiums during the policyholder's working lifetime

to buy an annuity upon retirement. How this line of business was valued was far and away the most important aspect of the annual valuation of liabilities for regulatory purposes.

64. Policyholders, who received an annual statement showing how much their policy was worth, might reasonably have expected the Society's liability to them might be valued using the contractual value shown on those statements (called the 'Guaranteed Policy Fund' or 'GPF'). However this was not the case. Throughout the period 1988 to 1999, the regulators allowed Equitable Life's actuaries to value such policies at a discount from the GPF, sometimes to a very substantial extent.
65. The largest differential between the GPF and the regulatory value, was applied in respect of 1990. At that point, aggregate policy values (i.e. liabilities to policyholders) amounted to £4bn, plus a guaranteed interest rate of 3.5% p.a. written into policies. The Society sought to demonstrate that assets of £1.9bn returning 7.25% for the next 18 years (years to the average retirement date) would be enough upon maturity to meet the present £4bn of aggregate guaranteed policy values plus the guaranteed interest rate. By this device, the Society claimed that differential of 3.75% p.a. (the difference between 3.5% and 7.25%) applied over 18 years reduced aggregate guaranteed policy values of just under £4,000m to liabilities for regulatory purposes of £1,900m. In short, by far the largest section of the Society's business was valued for regulatory purposes at half price. This took no account of any final or terminal bonuses.
66. Because of the fall in market values during 1990, it was possible for the Society to obtain an annual yield upon its spread of assets of about 8.5% p.a. after expenses. If 7.25% p.a. was going to be needed for the next 18 years just to cover the existing policy values plus the guaranteed interest rate, the regulators might reasonably have asked where the rest of the total reversionary bonus (another 4% p.a.) was to come from. This was an issue of policyholders' reasonable expectations.
67. The obvious potential of the Valuation Interest Rate differential for unduly reducing regulatory values meant that there were constraints upon how it could be used:
  - a. There were general requirements to use prudent assumptions and to have regard to the yields being obtained on existing assets.<sup>2</sup>
  - b. These were backed up by specific rules as to the rates that could be used in respect of particular liabilities and the assets supporting them.
  - c. Actuarial professional guidance required regard to be had to policyholders' reasonable expectations, in particular to make allowance for future reversionary bonuses.
  - d. The period of accumulation and discounting was restricted to that to the policyholder's earliest contractual retirement date.

---

<sup>2</sup> See regulation 54 of the Insurance Companies Regulations 1981.

- e. From the 1994 return onwards, there was a requirement to recognise the distribution of profits in an appropriate way over the duration of each policy.
68. Discussing the valuation interest rates, the Ombudsman explained at [177] of Chapter 10:
- Using higher valuation interest rates to calculate the Mathematical Reserves than was supportable by the assets held by the Society meant that the amount of the liabilities that were used when calculating the solvency position of the Society would be significantly understated, thus giving a more favourable impression of its financial condition.
69. She further explained that the Society's approach to discounting "appeared to suggest that a significant part amount of any future surplus would be required simply to fund guaranteed benefits" (ibid. at [189]). She also found that
- the information within the Society's returns gave rise to serious questions about whether the Society could afford the level of bonus it was paying and whether it could continue to pay out at that level, in a situation in which, as GAD knew, the Society was unique in illustrating to its policyholders the full policy fund value, including terminal bonus. (ibid. at [191])
70. The Response accepts the Ombudsman's findings of maladministration but rejects her findings of injustice. In respect of valuation interest rates, the Response argues at [4.34] that the finding did not consider whether the regulatory failure in question would or could have resulted in injustice; and it goes on to conclude that no injustice did arise. The reasoning is:
- 4.35 The Ombudsman's analysis does not demonstrate that Equitable Life's use of valuation interest rates failed to comply with the regulations applicable at the time. Indeed, the Ombudsman accepts that it may now be possible to show that Equitable Life was in fact acting appropriately as regards its approach to valuation interest rates (Chapter 10, paragraph 186). As a result, the Government does not share the view in the Ombudsman's report that the published information contained in Equitable Life's regulatory returns would have been different had GAD questioned Equitable Life's approach. Consequently, in the Government's view, no injustice to policyholders or others reading the regulatory returns can be said to have resulted from this aspect of the maladministration found by the Ombudsman.
71. The Response then sets out the Government's assessment of the available material which leads it to conclude either that "that there is no sound basis for considering that an attempt by GAD to investigate this issue would have resulted in any changes to the contents of Equitable Life's regulatory returns in the relevant years" ([4.39] and [4.46]) or that "the Government does not share the Ombudsman's view that any attempt by GAD to investigate this issue would have resulted in changes to the content of Equitable Life's regulatory returns in the relevant years" ([4.43]). We would be grateful if you could explain to us why the Response uses different language in the latter case.
72. The Response at [4.53] refers to advice that the bonus allowances set aside by the Society "paid sufficient regard to the reasonable

expectations of policyholders in the context of the regulatory regime in place at the time". It also concludes that the available data for the relevant period

...therefore demonstrates that Equitable Life did have sufficient reserves in place, for the purposes of the regulatory requirements applicable at the time, to meet the cost of future bonuses from 1996. From that date future bonuses can be said to have been affordable and sustainable at levels which would have met policyholders' reasonable expectations. (Response [4.54])

73. That data exists only for the 1996 returns onwards but the Response continues:

The Government is advised that, since the approach outlined above was standard actuarial practice, there is no reason to consider that Equitable Life's approach to future bonuses for the period 1990 to 1993 (and indeed the years 1994 and 1995 covered by the Ombudsman's fourth finding) - in respect of which corresponding data is not available - would not have been similar, with bonus declarations for this period also being affordable and sustainable. (ibid.)

74. A number of criticisms may be made of this approach.

*Actuarial advice*

75. It is clear that the rebuttal contained in the Response is based on actuarial advice. The Response sets out the conclusions of that advice without setting out the detail of that advice (or indeed its source) in a way which would enable others to assess the cogency of the Government's reasons for rejecting the Ombudsman's conclusions. Given the careful process which has been undertaken, we consider that the Government should disclose the full advice (and if advice has been received from more than one source, all such advice) so that its cogency can be assessed.
76. There is particular reason to question the cogency of the Government's preferred view that the Society's approach was "standard actuarial practice". It did not find favour with the Ombudsman's actuarial adviser, and Lord Penrose found that it was "not consistent with best actuarial practice" and "inconsistent with an intuitive view of the Society's ability to pay" (Chapter 19, [51]). This was also one of the practices which he described as being "of dubious actuarial merit" (Chapter 19, [240(5)], page 727).
77. We reserve the right to make further observations on this aspect of the matter in the light of the advice of our client's own actuary and after he has had an opportunity to consider the Government's advice.
- Policyholders' reasonable expectations*
78. The Ombudsman found, and the Government appears to accept, that whether the Society was discounting its liabilities in an impermissible way and whether the level of bonus that it was declaring was affordable and could be sustained "went to the heart of the interests of with-profits policyholders and of the Society's ability to fulfil their reasonable expectations" (Chapter 11, [35]).

79. We do not consider that the Response justifies the Government's preferred conclusion that the Society's policy "paid sufficient regard to the reasonable expectations of policyholders<sup>3</sup> in the context of the regulatory regime in place at the time". For the reasons set out in paragraphs 65 and 66 above, it was clear to GAD that the Society's policy raised very serious questions. Even if the returns complied with the regulations, that did not exhaust the regulator's powers of intervention, and it could have relied on section 45 of the Insurance Companies Act 1982. In reaching its conclusions, the Response does not address this possibility.

*Failure to address the finding of injustice*

80. By limiting itself to the questions whether the Society was in breach of regulatory requirements and whether the content of the returns would have been any different if GAD had made further inquiries, the Response does not cover the extent of the maladministration and consequent injustice which the Ombudsman found.

81. The Ombudsman explained in Chapter 10 [187]:

... I have to consider whether the information available at the time enabled GAD, in carrying out the scrutiny of the Society's returns, to be satisfied that the Society was acting in accordance with the obligations to which it was subject - and in such a manner that would not give rise to the risk that it would be unable to fulfil the reasonable expectations of its policyholders and potential policyholders.

82. In concluding that there was maladministration, in Chapter 11 at [34], the Ombudsman explained that:

Seeking to ensure that the regulatory returns of an insurance company were accurate and complete was at the heart of the role of the prudential regulators, acting with the advice and assistance of GAD.

83. She therefore found (in paragraphs [38] and [39] of Chapter 12) that once questions had arisen about the prudence of the Society's valuations and bonus declarations, GAD were required to (and did not) satisfy themselves on the issues as part of the advice they gave to the regulators, in order to enable them to verify the Society's financial position and to ensure that it was acting in conformity with its obligations.

84. On this basis the Ombudsman concluded (at [17] in Chapter 12) that GAD could not be satisfied the Society was acting prudently and with proper regard to the interests and reasonable expectations of policyholders. As a further consequence:

... the impression was given to existing and potential policyholders that the Society was financially sound and able to pay generous bonuses, when the prudential regulators and GAD could not have been satisfied on either point. (ibid. [18])

85. At [60]-[66] the Ombudsman set out the general consequences of lack of scrutiny and the resulting inadequacy of the returns.

---

<sup>3</sup> As required by regulation 64 of the Insurance Companies Regulation (1994 SI No. 1516).

Paragraphs [61] - [63] are set out at paragraph 27 above. The Ombudsman explained the nature of the injustice in [92] as follows:

I have found that the returns published by the Society in every year from 1990 to 1996 were unreliable as a source of information for existing and potential policyholders and their advisers. The prudential regulators and GAD did not verify the position in respect of the reserves held for the guarantees contained in many of the Society's policies, in respect of the valuation rates of interest applied by the Society when calculating its liabilities, and in respect of the true amount of free assets that the Society possessed.

86. Those matters, she found, were "central to any assessment of the financial condition of the Society" (ibid. [93]) and at [94] concluded:

I consider that those deficiencies and omissions undermined the ability of the users of the returns to be able to rely on the information contained within those returns as being complete, accurate, and compliant with what the law required. Given that one of the fundamental purposes of those returns was the ability to rely on this information, I consider that injustice was capable of resulting from such maladministration.

87. At [100] she therefore concludes:

I find that injustice was sustained by any policyholder who relied on the information contained in the Society's returns for 1990 to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision as a result of such reliance. Where a policyholder neither relied on this information nor suffered a loss of either type, I find that no injustice resulted from this maladministration.

88. The Response does not meet this finding. In her second Memorandum to PASC the Ombudsman at [7] ff pointed to the scrutiny of returns issue as an example of "findings which I did not make". She explained that the Government answered injustice by asserting that intervention would not have resulted in any changes to the contents of the regulatory returns in the relevant years. She then explained her finding, as set out at paragraph 31 above.

*Availability of data - affordability and sustainability of bonuses*

89. We note that it is only from the 1996 returns that data is available to show the difference between the valuation interest rate and its risk adjusted yield (Response [4.53]). The Response goes on to assert ([4.54]) - on the basis of (undisclosed) advice as to standard actuarial practice - that:

there is no reason to consider that Equitable Life's approach to future bonuses for the period 1990 to 1993 (and indeed the years 1994 and 1995 covered by the Ombudsman's fourth finding) - in respect of which corresponding data is not available - would not have been similar, with bonus declarations for this period also being affordable and sustainable.

90. However, the very absence of data underlines the Ombudsman's finding that the Society's returns could not be regarded by policyholders as a reliable source of information. We would also refer to EQUI's findings related to the evaluation of liabilities set out as 8, 10 and 12 of their conclusions at paragraph 34 above.

### Finding 3 - Differential terminal bonus policy

91. The Society attempted to deal with the Guaranteed Annuity Rate problem in 1993 by changing its terminal bonus policy, so that the burden fell mostly upon policyholders instead of on the Society. GAD's failure to follow up the disclosure of the differential terminal bonus policy in the Return for that year meant that it did not discover the extent of the Society's exposure to the GAR problem or the fact that it had made no provision for this liability in its Returns.
92. The Ombudsman found maladministration in that:
- the failure by GAD, when the introduction of the Society's differential terminal bonus policy, intimated within the Society's 1993 returns, was identified by GAD as part of their scrutiny of those returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders, constitutes a departure from the applicable standard that was both unreasonable in the circumstances and was far short of acceptable standards of good administration. (Chapter 12, at [54])
93. The Ombudsman made her findings of fact on the matter in [203] ff in Chapter 10. At [240] she explained:
- I consider that the disclosure in the 1993 returns of the differential terminal bonus policy raised three separate issues which should have been considered and addressed: the first being how the Society's new policy impacted on the reasonable expectations of its existing policyholders; the second being whether that policy was being clearly described to potential policyholders; and the third being its impact on the Society's approach to reserving.
94. In the following paragraphs, she set out the reasons for concluding that a significant change in determination of the value of benefits would affect policyholders' reasonable expectations, including her assertion that this was the view of the actuarial profession. At [245] she concluded:
- Given all of the above, I consider that GAD should have pursued with Equitable the new policy, which GAD noted had the effect of reducing bonuses, in order to be able to advise the prudential regulators as to whether the differential terminal bonus policy accorded with policyholders' reasonable expectations.
95. At [41] ff of Chapter 11, the Ombudsman considered whether there was maladministration. Of particular note are the following:
49. The Society's 1993 returns had disclosed the differential terminal bonus policy which the Society had introduced abruptly. That policy, as GAD noted, was new and would have the effect of reducing the terminal bonus payable to certain policyholders. Yet GAD failed to enquire as to what the new bonus policy was, whether it was being properly described in the Society's publications, and what the rationale was for this change of a central policy in the operation of any life insurance company.
52. In a context in which such a central policy was changed in a direction which had the effect of reducing the proceeds that some of the Society's policyholders would receive and where, on the

information before GAD at the time, it appeared that no disclosure to policyholders of this change in policy was being effected, I find it surprising that GAD did not ask as part of the detailed scrutiny process for an explanation of the new system and for more details about its rationale. I find it even more surprising that GAD did not inform the DTI that all this had occurred.

53. There could be no doubt in such circumstances that significant questions arose in respect of the reasonable expectations of the Society's policyholders. GAD was required by the service level agreement to bring such matters to the attention of the DTI. However, GAD did not do so. That was a serious omission.

96. At [4.60] and [4.61] of the Response the Government accepts that GAD's failure to alert the regulator to Equitable's introduction of the differential terminal bonus policy was maladministration; but it does not accept that there was maladministration in GAD's failure to raise the matter with Equitable or its failure to seek a rationale for the policy or how it was being communicated to policyholders. The reasons are set out in the following paragraphs:

4.62 ... Equitable Life's differential terminal bonus policy was not unusual or out of the ordinary and was widely regarded by the actuarial profession as permissible at the relevant time. Thus GAD had no reason to single Equitable Life out for investigation simply by reason of its differential terminal bonus policy.

4.63 ... It is only with the benefit of hindsight, including knowledge of the House of Lords' decision in 2000, that the implications of the differential terminal bonus policy for Equitable Life became clear.

4.64 ... the Ombudsman makes no express finding that the adoption of the differential terminal bonus policy by Equitable Life was an impermissible means of controlling its underlying exposure to future liabilities, or that Equitable Life was at that time in breach of any reserving requirements.

97. These arguments appear to be the same as those which were deployed by the public bodies at Chapter 10, [253] ff. The Ombudsman rejected them for the reasons set out in [280] ff. The Response has not given any cogent reasons for rejecting the Ombudsman's evaluation of their submissions. It has simply restated its position. The Government's response in [4.62] - [4.64] does not appear to address the Ombudsman's conclusions as to maladministration set out in [49] - [53] which are detailed above, and does not, therefore, provide a sufficient basis for rejecting the findings.
98. Moreover the cogency of the position in the Response must also be assessed having regard to the content of Lord Penrose's report. The Government's position appears to be inconsistent with the concession of the DTI and GAD, made to Lord Penrose, that "there would have been scope for the problems to have been addressed earlier" (Chapter 19, at [190]). Moreover, Lord Penrose concluded that failure to follow up the information "constituted a serious lapse in regulation" (ibid. at [235]); that "any reasonably diligent inquiry would have elicited information .... that would have informed GAD

and the regulators of the problem before it became a disaster for the Society and its policyholders” (ibid.); and that “[it] was GAD’s responsibility to submit the returns to scrutiny, and to raise issues with the regulators where they were not permitted to pursue them directly” (ibid. at [236]).

99. The Ombudsman set out the consequences of maladministration in Chapter 12 at [20] ff. In particular she found that it is likely that the Society would have taken legal advice earlier, and although that advice would probably have been the same, it is possible that the Society would have decided sooner to test the policy in the courts. The decision to test the policy was made in response to the growing number of complaints about it. If the regulators had required full disclosure of the differential terminal bonus policy in the Society’s literature at an earlier stage, it is likely that complaints would have come earlier. As a change in policy conditions it should have been communicated to policyholders as soon as it was made: in the Court of Appeal’s decision in the *Hyman* case, Lord Woolf confirmed that the policy-holder was entitled to be told if there were to be differential final bonuses depending on which Policy option was chosen, since the neutralisation of the benefit of the GAR was not a course which could be reasonably foreseen (paragraph 53(i) of his judgment, which was approved by the House of Lords).
100. At [120] of Chapter 12, the Ombudsman said that she was unable to conclude that financial loss resulted from the maladministration, since she could not make findings about what policyholders would or might have done differently had the Society been constrained, as a result of regulatory attention at the time of the introduction of the differential terminal bonus policy, to address at an earlier date the issue of reserving for the liabilities arising from these guarantees. However, she concluded at [121] that:
- ...the loss of opportunities to take informed decisions about their financial affairs during the period from July 1994 to April 1999 in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated constitutes injustice to policyholders and I consequently make a finding that policyholders suffered such injustice as a result of maladministration.
101. The Government has rejected the Ombudsman’s findings as to what would have happened had the regulators questioned the policy earlier, asserting that the consequent finding of injustice is based on speculative conclusions. In summary the Government contends that even if the regulators had raised the question of the GAR problem, none of the consequences envisaged by the PO would have actually transpired. These included, taking earlier legal advice, testing the policy earlier in the Court and making provision earlier in its returns.
102. At [4.69] the Government “respectfully disagrees” with the Ombudsman, indicating that
- The trigger for Equitable Life commencing the *Hyman* litigation was the growing number of complaints from policyholders regarding the application of the differential terminal bonus policy. Those complaints were not received by Equitable Life in any significant number until 1997 and 1998, when the GARs became attractive and when terminal bonuses

were being cut. The Government does not consider that there is any reason to suggest that Equitable Life was in breach of any prudential regulatory requirements by failing to inform policyholders of its decision to adopt the policy via its literature or that GAD/the regulator should have required it to do so. As such the information provided to policyholders was a matter for Equitable Life's board and management, not for the regulator.

103. The Government claims that in the absence of regulatory breaches, the influence of the regulators was limited. This appears to be inconsistent with the position advanced to Lord Penrose (see paragraph 98 above), where the burden of the representations from GAD and the DTI was that they had no knowledge of the differential terminal bonus policy until 1998. Thus at [4.71] of the Response, the Government says:

In the absence of any suggestion that the use of a differential terminal bonus policy was considered at the time to be an impermissible means of managing exposure to future liabilities, the Government does not consider that there is any basis to conclude that questioning Equitable Life's adoption of the policy would have led to earlier reserving for GAR exposure. In this respect, the Government notes that the Ombudsman does not contend that Equitable Life was required, **at the time it adopted the policy, to reserve for GARs. This was required only after GARs became valuable when market interest rates fell. This did not happen until 1995.** In any event, the level of reserving which this would have required in 1995 and 1996 would have been easily achievable by Equitable Life and would have had little or no impact on the liabilities which **crystallised as a result of the House of Lords' judgment.** (emphasis added)

104. These do not amount to cogent reasons for rejecting (or even respectfully disagreeing with) the Ombudsman's findings, for the following reasons.
- a. The Response accepts at [4.106] that "the prevailing level of interest rates at the end of 1995 was such that the GARs were valuable at that date", and that in consequence the regulator should have required the Society to establish explicit reserves for its GAR liability in the 1995 and 1996 returns. The Baird report disclosed that in fact interest rates first fell below the 'in the money' line (i.e. the point at which current interest rates equalled the interest rate assumed in setting the GAR pension) in 1993 and this is what precipitated Equitable Life's adoption of the differential terminal bonus policy.
  - b. The policy itself attempted to make policyholders pay for their own GARs out of their terminal bonuses. This did not affect the GAR liability which the Society had in respect of the guaranteed portion of any policy and which needed to be provided in the returns.
  - c. Any detailed consideration of the GAR would have revealed that Equitable Life was hugely over-exposed to the GAR risk. The GAR right was contained in all pension policies issued up to 1988, policyholders could continue to pay in additional premiums and

the GAR right could be exercised over a 15 year period from age 60 to 75.

- d. Whether there was an actual liability for 1993 or material ones for 1995 and 1996 (which our clients' actuary estimates at £435m and £483m respectively) is of less importance than the establishing of the principle in the minds of both the Society and GAD that provision would need to be considered for each future year. The Society would not then have been faced with finding £1.6bn in 1998, having made no previous provision whatsoever.
- e. The suggestion that the liabilities which crystallised as a result of the House of Lords judgment had anything to do with reserving is quite wrong. The reserving issue eventually raised by GAD in 1998 concerned the GAR on contractual values. The House of Lords' decision concerned the interaction of the GAR with terminal bonuses. This was recognised by the public bodies in their joint response on maladministration: see Part 4 of the Ombudsman's report at [141] (page 84):

“It should be noted that what led to ELAS's problems after the House of Lords judgment was primarily the cost of the honouring the GARs on the *non-guaranteed* (i.e. terminal bonus) part of maturity values. This was because the effect of the judgment was that ELAS was not allowed to reduce the terminal bonus to offset this cost if and when the GAR option was exercised. This cost was determined by the prevailing investment conditions (as reflected in the valuation assumptions used in the base valuation) at the time, and *not* in any way by the reduced interest rate scenario provided for by the resilience test. It was quite separate from the cost of honouring the GARs on the *guaranteed* part of maturity values, which had already been fully reserved for by ELAS, at the insistence of the regulator, by the time of the House of Lords judgment (subject to part of this reserve being offset by the GAR reinsurance treaty, which had to be renegotiated as a result of the judgment).”

## 5 - Presentation of Society's two valuation results

105. The Ombudsman found at [84] in Chapter 11 that
  - the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society, constitutes maladministration.
106. This concerns the method used by the Society to calculate their Mathematical Reserves, i.e. the provision made by an insurer to cover liabilities (excluding liabilities which have fallen due) arising under or in connection with contracts for long-term business.

107. The Equitable's returns between 1990 and 1996 used an alternative method to that provided by the regulations. The appendix to the returns purported to include the regulatory valuation, but omitted to include resilience reserves, i.e. reserves, calculated in accordance with ICR 1981 or ICR 1994, which relate to an insurance company's ability to cover mismatches of assets and liabilities that adverse movements in asset values may disclose.
108. The Ombudsman summarised her findings in Chapter 10 at [19] - [27]. She explained her detailed findings at [344] ff. At [379] ff she set out the submissions from public bodies and she evaluated them at [388] ff. She concluded that GAD fell short of the requisite standard by failing to ask for the 1995 figure and by failing to follow up on the fact that the information omitted from the returns led to a stronger Standard & Poor's rating than it should. She noted that this was used in briefings to Ministers and response to inquiries. The Ombudsman explains in Chapter 10 at [26] that:
- Those ratings, which were provided to GAD by the Society and retained on GAD's files, were used as part of briefing for Ministers and others. Standard & Poor's erroneously concluded that the Society was stronger than it really was. This was as a direct result of the information which GAD knew was missing from the returns.
109. Details of the Government's reliance on Standard & Poor's ratings are set out in Part 3 of the Ombudsman's report. Reference should also be made to Chapter 16 of the Penrose report at [123], which referred to a DTI briefing note for the President of the Board of Trade in February 1994 which stated:
- The latest returns submitted to DTI show its solvency position to be strong. In late 1993, the company received an 'AA' rating from Standard & Poor's for its excellent claims paying ability.
110. At [177] Lord Penrose referred to an internal DTI note dated 8 November 1995 which read:
- ... EL has a different way of calculating their reserves than most [companies] but surely their financial strength can be ascertained from the DTI returns - albeit not necessarily from Form 9. Otherwise - how [would] S+P be able to give them such a good rating?
- He recorded that a similar note was sent to GAD, and noted that regulators' reliance on Standard & Poor's rating of the Society and the suggestion that it must have been based on the returns were "surprising".
111. The Ombudsman dealt with the consequences of the finding of maladministration in Chapter 12 at [33] ff. In summary she found:
- [34] those reading Society's returns during this period were capable of being misled as to the Society's true financial position.
- [35] those who used the information and conclusions drawn from it were actually misled.

[36] GAD was unable to verify the true financial position of the Society in the 1995 returns.

[37] That maladministration resulted in the reader of the returns not having the information that was before GAD and which, arguably, should have been available to all readers of the Society's published returns. No action was taken when it was clear that those readers were misconstruing the information that was provided. Maladministration also resulted in those who expressed concerns about the Society's solvency being reassured on grounds which were not sustainable.

112. The Ombudsman found injustice resulted (see Chapter 12 at [82] ff). At [89] ff she found that together with findings 2 and 4, the regulatory returns for 1990 to 1996 were unreliable, and that there was financial loss, or loss of the opportunity to take an informed decision, where a person reasonably relied on the information in those returns.
113. The Government has accepted ([4.117]) that the failure to request the figure for the resilience reserve in the Society's appendix valuation in its 1995 returns constituted maladministration. The Government has not accepted that GAD or the regulator were under any duty to act in response to the credit rating produced by Standard & Poor's ([4.119]). Moreover, the Government has rejected the Ombudsman's finding of injustice.
114. The Response sets out the Government's case on maladministration at [4.120] to [4.122]. It is to be noted that the submissions are precisely the same (in some cases the very same language) as those recorded by the Ombudsman at [382], [385] and [386] of Chapter 10. In essence they are:
  - a. There was no regulatory requirement on the Society to include the amount of resilience reserves. Therefore neither rating agencies nor others were misled;
  - b. Rating agencies had access not just to the returns but to unpublished information, and they could discuss issues arising with the companies they were rating;
  - c. Any failure to recognise that the amount of the resilience reserve had not been disclosed was entirely a matter for the agencies. The regulator and GAD had no duty to vet their understanding or rectify perceived inaccuracies or misunderstandings.
115. The Ombudsman dealt with those submissions at [393] - [395] of Chapter 10 in the following terms:

393 While I accept that the prudential regulators and GAD were not responsible for the content of the ratings produced by such agencies, that does not explain why the Society's ratings - despite them containing assessments which GAD should have known were fundamentally flawed - were used by GAD and by the prudential regulators in a number of contexts - such as in scrutiny reports, as briefing for Ministers and to deal with enquiries as to the strength of the Society.

394 The flaws in those ratings derived not from error on the part of those producing them but were a direct result of the way in which the Society presented its returns without objection from GAD.

395 Given that this presentation was not contrary to the Regulations, I do not suggest that GAD should have recommended intervention action or action under section 22(5) of the 1982 Act. However, I consider that GAD should have alerted the prudential regulators to the issue and should have recommended that those ratings should not be used as briefing material and to respond to enquiries.

116. The Government has given no cogent reasons, indeed no reasons at all, for rejecting those findings. In her Memorandum to PASC dated 9 February 2009, the Ombudsman refers to:

the failure in the Government's response to address the full basis on which I found that the prudential regulators and GAD should have considered action in relation to the presentation by Equitable Life of two valuations - not dealing with why GAD and others used the ratings by Standard & Poor's - which they should have realised were inaccurate - to brief Ministers or to address policyholder enquiries and complaints

## 6 Financial reinsurance

117. The FSA allowed the Society to take £800 million - £1000 million credit for a reinsurance policy that it knew was worthless.
118. The Treasury took over prudential regulation from the DTI in 1998 and soon identified Equitable Life as a problem case, particularly as regards its serious GAR liability, which by that time was estimated to be £1.6bn. It was clear that inclusion of such a liability in the 1998 returns would threaten the Society's solvency to the point of putting at risk its 1998 bonus declaration, omission of which was recognised as commercial suicide. Even before that year had ended, a meeting was held with the Society at which this serious situation was discussed. Re-insurance was mentioned as a possible means of relief. The Treasury expressed its willingness to grant a concession allowing credit to be taken for such re-insurance, even if it could not be actually completed by 31 December 1998.
119. The Society then arranged a form of re-insurance with an Irish company for a premium of (initially) £150,000. This was claimed by Equitable Life as an asset worth £800 million. GAD examined the transaction and found it insufficient to justify such a credit. Regardless of GAD's view, the FSA's<sup>4</sup> Director of Insurance and Managing Director told their Board that satisfactory re-insurance cover had been arranged, and the Society declared its 1998 bonus in March 1999 in the usual way.
120. The actual re-insurance treaty was not signed until October 1999 and the Treasury never issued any concession to allow back-dating to

---

<sup>4</sup> The FSA took over most aspects of prudential regulation as the Treasury's sub-contractor from January 1999.

1998. Credit for this treaty, of the order of £800 - 1000m, was allowed in the 1998 and subsequent returns.

121. The Ombudsman found at [101] in Chapter 12 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.

122. The Government's acceptance of the finding of maladministration appears to be more limited. It accepts that "the Treaty was such as to raise questions which should have been resolved by the regulator before permitting credit to be taken for it in the regulatory returns" ([4.133]). The basis for this acceptance is set out in [4.134] of the Response as follows:

This acceptance is based on the fact that there is no evidence that the FSA satisfactorily resolved issues which it (and GAD on its behalf) had raised with Equitable Life as to the requirements of the Treaty. The FSA should therefore not have been satisfied that the executed reinsurance agreement was such as to justify the treatment of the Treaty in Equitable Life's returns for 1998, 1999 and 2000. In particular, the FSA did not resolve concerns as to whether the credit which Equitable Life took for the Treaty in its returns was properly justified by the provisions of the Treaty itself.

123. The implication of this limited acceptance appears to be that the Government considers that the FSA might have been able to resolve the issues raised by the Treaty. It is clear, however, from [448] - [450] of Chapter 10 that the Ombudsman found that this was "a transaction which had no genuine economic purpose" and "did not constitute reinsurance and therefore could not be taken into account in determining the Society's long term liabilities." The Government has not rejected that finding, and nothing else in the Response indicates a reason for doing so.

124. It appears that the Government does not accept that there would have been no bonus declaration in March 1999. This becomes apparent when dealing with injustice. It is necessary to set matters out at length in order to assess the cogency of the Government's reasons for rejecting her findings of injustice and, by implication, her finding as to the full extent of the maladministration.

125. The Ombudsman set out the consequences of the maladministration that she had found at [39] - [44] of Chapter 12 in the following terms:

39 One consequence of the acts and omissions of the FSA in this regard was that the Society was permitted to declare a bonus in March 1999. Had the Society not done so, a public warning would have been given to those considering investing in the Society for the first time or to those considering making further contributions to existing policies that the Society was in significant financial difficulty.

40 Another consequence of those acts and omissions was that the solvency position of the Society, as published in April 1999 within its 1998 returns, was misrepresented. Those reading the Society's published 1998 returns would have been misled as to the strength of the Society's financial position. That reinforced the misleading message as to the strength of the financial position of the Society which had been given by the declaration of a bonus a month earlier.

41 A further consequence of the acts and omissions of the FSA was that the ongoing weakness of the Society's financial position was hidden from public view in the Society's published returns for 1999 and 2000. Those considering their options - whether to invest, to make further contributions to existing policies, to convert a policy into an annuity, or simply to stay - were given a misleading picture of the true position faced by the Society and of its solvency position.

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.

43 That maladministration also resulted in existing and potential policyholders making highly important decisions - some of which were irreversible - about their financial affairs without the benefit of information which the system of prudential regulation was designed to provide to them, in order to enable them to make informed choices.

126. As to injustice, the Ombudsman found that, if the Society had sought to declare a bonus the FSA would have taken action to prevent it on PRE grounds. The weakness of the Society would have been revealed by 1 May 1999. At [129] - [130] she found the following:

129 I also consider that many fewer existing policyholders would have taken out a with-profits annuity, from which there was no subsequent prospect of exit.

130 Furthermore, I consider that many fewer existing policyholders would have made further contributions to existing policies in the circumstances which would have prevailed had this maladministration not occurred.

127. She found at [146] 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.

128. The Government purports to accept the finding of injustice, to the extent that "Equitable's returns would have given a materially different picture of Equitable's solvency had no credit for the reinsurance treaty been permitted by the regulator." But it continues: "Notwithstanding this acceptance, the Government wishes to make the following observations on the Ombudsman's injustice finding." We assume, therefore, that Sir John Chadwick is required to give his advice on the basis of those observations, since

his Terms of Reference require him to “[a]ccept as correct and be able to consider all of the Ombudsman’s findings of both maladministration and injustice in so far as those findings are **accepted by the Government**” (Response page 45, emphasis added). Sir John Chadwick is also enjoined to:

Make such other findings of fact (if any) as he may think necessary in the light of the evidence contained in the publicly available reports produced to date, including the Penrose Report, the Ombudsman’s Report and the Government’s response to that report. (emphasis added)

129. The Response then sets out the Government’s “observations” as follows (with emphasis added):

4.136 The Ombudsman has found that, had credit for the reinsurance treaty not been permitted, Equitable Life would have been unlikely to have declared a bonus in 1999 and earlier closure to new business would have followed.<sup>5</sup> It is the Ombudsman’s view that such consequences would, “on the balance of probabilities,” have followed had the reinsurance treaty not been available to Equitable Life.

4.137 The Government has considered the Ombudsman’s analysis leading to the finding of injustice and in particular the alternative scenarios which may have unfolded had credit for the reinsurance treaty not been permitted by the regulator.

4.138 The Government accepts that any consideration of the consequences which might have followed a decision not to permit credit being taken for the reinsurance treaty is necessarily speculative. However, in the context of what is now known about the conduct of Equitable Life, which later did everything possible to remain open to new business, **it is almost certain that Equitable Life would have investigated all possible courses of action so as to be able legitimately to bolster its solvency position in the 1998 returns and to declare a bonus in 1999.**

4.139 Such options are likely to have included a combination of alternative reinsurance cover, adjustment of the margins in Equitable Life’s regulatory returns, increased use of the future profits implicit item and reducing some of its equity exposure in favour of fixed interest assets, most probably through the use of derivatives. It is also possible, in light of the apparent intentions of the parties to the reinsurance treaty as to its proper interpretation, that had their attention been drawn to the fact that it did not bear such an interpretation, they would have renegotiated its terms.

4.140 These options would have impacted on Equitable Life’s published solvency position to different degrees, depending on which were utilised and to what degree, and their availability should be taken into account when assessing the impact and nature of the injustice flowing from this finding of maladministration. Recourse to any of these options would also have impacted on Equitable Life’s ability to justify to the regulator its ability to pay a bonus in 1999.

---

<sup>5</sup> It is to be noted that the Ombudsman did not find that earlier closure to new business would necessarily have followed as suggested by the Response at [4.136].

130. The Ombudsman dealt with the possible alternative courses of action at some length in Chapter 12 of her report at [133] ff in the following terms:

133 On 24 November 1998, following an earlier meeting with the Treasury, as prudential regulators, and GAD, the Society had begun to consider what options it had in the light of the view that had been expressed by those regulators that the Society needed to take action to improve its solvency position if it wanted to declare a bonus.

134 For any such action to have been taken into account within the Society's 1998 returns, thus contributing to its reported solvency position, it would either have to have been in place on or before 31 December 1998 or have been at such an advanced stage of completion that a concession could reasonably have been granted by the prudential regulators by that date.

135 That gave the Society no more than six weeks - and, given the holiday period which affected the ability to take action in the markets, probably considerably less - to effect any remedial action.

136 In that context, and given that many other options, such as 'genuine' reinsurance, would have been so expensive as not to be realistic in the circumstances in which it found itself at that time, the Society recognised that its main option was financial reinsurance.

137 The alternative was to publish a very weak solvency position. I acknowledge, however, that it would, in theory, have been possible for the Society to have sought to sell equities and buy into gilts, thus improving its asset distribution for solvency purposes. That might have improved the reported position of the Society to a reasonable degree.

138 However, given the lack at that time of public knowledge of the extent and full nature of the difficulties that the Society faced, I consider that a significant switch from equity holdings into gilts compressed into a short timescale before the end of the year might have been difficult to achieve.

139 This ran the risk of causing additional damage to the value of the Society if it had been viewed, as a result, as a 'distressed seller'. A move to a more defensive investment portfolio would also have further weakened the Society's marketing message. This would not have mitigated the public relations impact on the Society; indeed, it would have reinforced it.

131. The Government has not rejected those latter findings. In its Memorandum to PASC of 6 March 2009, the Treasury indicates that the Response "sought to highlight the fact that no definite conclusions could be drawn as to what would have happened had Equitable Life considered alternative options" (at [38]). However, the Ombudsman considered the options and made her findings on the balance of probabilities (Chapter 12 at [126] and [140]). The Response does not say that these findings are wrong, or that the Society would have been able to declare a bonus. It suggests only that "it is almost certain that Equitable Life would have investigated all possible courses of action so as to be able legitimately to bolster its solvency position in the 1998 returns and to declare a bonus in 1999". We assume that it goes no further because its actuarial advice (which you have not disclosed) does not support such an assertion.

- 
132. Our clients and their actuary have considered the alternatives which the Response advances as a reason for doubting the Ombudsman's findings (if that is their intention). They consider that they do not advance cogent reasons for doing so.
133. The Response suggests that the Society had numerous other options to avoid the £800m dent in its solvency numbers, which the regulators' rejection of the re-insurance policy would have entailed.
134. This is simply not credible, because of the timing of events. The contract itself was not in force at the end of 1998 and GAD did not reject its efficacy until February 1999. It is most unlikely that any negotiations which the Society had commenced with another re-insurer at that point could have provided any certainty that a new policy might be approved for 1998. In practice it continued throughout the spring and summer of 1999 to attempt re-negotiations of the IRECO treaty to make it 'approvable'. This is why it took so long to be signed.
135. As to the other alternatives advanced in the Response, (a) the Society could not have changed its asset mix for 1998 after that year had ended, and (b) our client's actuary's view is that there was no room for further use of 'future profits'. In any event, such use would have been perceived as a sign of great weakness.
136. It follows that all the Society was really left with was either showing a poor regulatory margin or cancelling its 1998 bonus, either of which would have had the sort of serious consequences envisaged by the Ombudsman.
137. We note that the Ombudsman commented on this matter in her second Memorandum to PASC as follow:
18. This is an attempt to reinterpret what I found and to limit the necessary consequences of that finding. I did not find that earlier closure to new business in formal terms would necessarily have followed proper action by the prudential regulators in relation to the credit that they permitted the Society to take for the reinsurance arrangement within the relevant regulatory returns.
19. What I found was that, absent maladministration, the true and published solvency position of the Society would have deterred potential investors from placing money with the Society, would have led to those considering converting their policy into an annuity to understand the true risks of such a course of action, and would have led to those not required to make further contributions to existing policies reconsidering the benefits of doing so.
20. Nor did I fail to address in my report the options said to be available to the Society and which are now put forward by the Government in its response as a potential means of limiting the direct consequences of the maladministration regarding the credit which the regulators permitted the Society to take and which hid the company's true financial position. Those options and (the lack of) their viability were addressed in paragraphs 122 to 147 of Chapter 12 of my report.
21. It is clear from the detailed chronology of events in Part 3 of my report that those options were not seen by the regulators at the time as being

viable. I also addressed later submissions, now echoed in the Government's response, within Chapter 10 of my report.

22. Given the extensive treatment of those questions within my report, not now addressed in any form by the Government in its response to that report, there is no basis on which such considerations can now be used to limit the consequences of the relevant finding.

### 10 Post-closure information

138. In Chapter 8 of her report, at [115] ff, the Ombudsman set out at great length the information about the Society which the FSA provided in the post-closure period. She made detailed findings in Chapter 10 at [615] - [698]. See, for example:

660. I consider that it is impossible to reconcile the reassurances that the FSA routinely provided with the information before the FSA - to which the FSA informed policyholders that they had had regard when concluding that the Society was solvent for regulatory purposes and always had been so solvent, and was meeting and always had met the regulatory requirements to which the Society was subject.

674. Yet the FSA told policyholders that, having monitored carefully the financial condition of the Society and based on the information available to the prudential regulators, the FSA was satisfied that the Society was able fully to meet its obligations and had not breached the regulatory requirements to which it was subject. That was misleading.

139. At [160] in Chapter 11, the Ombudsman made the following finding of maladministration:

I consider that the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business, constitutes maladministration. I therefore make such a finding of maladministration against the FSA.

140. At [4.179] of the Response, the Government accepts the Ombudsman's finding but apparently only to the extent that "it is accepted that the statement made in October 2001,<sup>6</sup> namely that Equitable Life remained solvent, but continued to face fundamental uncertainties following the House of Lords' judgment in Hyman, had the potential to mislead policyholders and others reading it." The rest of that paragraph appears to add a gloss to the finding by reference to the giving of "further thought" or "greater thought" to the information. The Government does not appear to have accepted the Ombudsman's finding of maladministration to the extent that it relates to the other statements made by the FSA during the post-closure period. However, the Response does not state that the Government has rejected those parts of the finding, nor does it give any reason for rejecting them. In the circumstances, there is no basis on which the Government might lawfully reject those findings.

---

<sup>6</sup> We assume this refers to the statement posted on the FSA's website on 8 October 2001 in response to the question 'is the Society solvent?': see Chapter 8 at [118].

141. The extent of the finding of maladministration is of significance in view of the Ombudsman's findings on injustice, which are linked to all the FSA's published information, not just the statement in October 2001. In Chapter 12, the Ombudsman finds:

57 The principal consequences of this deficient information were that reassurance was given to those who contacted the FSA to enquire about the financial position of the Society when that reassurance was not soundly based. Those who had regard to the information provided by the FSA made decisions about their financial affairs having regard to incomplete and inaccurate information provided by the FSA.

58 That maladministration resulted in misleading information about the position of the Society being provided to existing policyholders. Those policyholders were entitled, having regard to its source, to rely on that information as being accurate and not misleading.

This is of particular significance given that the Society effected a 16% cut in policy values in July 2001, i.e. before the October 2001 statement.

142. The Ombudsman accepted that in the post-closure period the Society was widely known to have been in financial difficulty and anyone who had regard to the information provided by the FSA could not be said to have acted reasonably if they relied on this information, without further inquiry, when making any decision about their financial affairs (see Chapter 12 at [162]). Her finding on injustice is set out at [167] - [168] of Chapter 12 as follows:

167 I consider that, in order to have sustained injustice as a result of this maladministration, those who acted in reliance on the information they received from the FSA and who suffered either a financial loss or a lost opportunity need also to show that such reliance was reasonable in the circumstances. That can only be determined at an individual level.

168 I find that injustice resulted from maladministration to all those who can show that they relied on misleading information provided by the FSA, that such reliance was reasonable in the circumstances, and that it led to a financial or other loss. Where all this cannot be shown, I find that no injustice resulted from this maladministration.

143. While the Government accepts the finding of injustice (Response [4.180]), it continues that "it is necessary to explain the basis on which it does so." We assume, again, that Sir John Chadwick is required to accept the Ombudsman's finding on injustice only to the extent that it is accepted by the Government and that he is therefore bound by the Government's limitations unless he considers it appropriate to obtain further evidence.

144. The Government's reasons for its more limited acceptance of injustice substantially repeat the submissions of the public bodies which the Ombudsman recorded at [677] ff of Chapter 10. Thus, [4.182] repeats the submission recorded at [683] and [4.184] and [4.186] repeat the submissions at [685]. The Ombudsman considered and rejected those submissions for the reasons set out at [686] ff. The Response gives no reasons for rejecting the Ombudsman's evaluation of the submissions. That evaluation provides an answer to the Government's reservation, which the Response does not rebut.

## Remedies

145. While the Government is not bound to accept the Ombudsman's recommendations as to remedy, in reaching a decision on such matters it must act lawfully and rationally. It must, therefore, take account of relevant considerations and ignore irrelevant ones; it must not frustrate any legitimate expectations; and it must not make arbitrary distinctions between persons who are similarly placed. In addition, it must not seek to add a gloss or limit the Ombudsman's findings as to maladministration or injustice where it has either not rejected them or it has not provided cogent reasons for preferring alternative conclusions. Any scheme which the Government establishes must comply with any other obligations which the law imposes on it. We shall consider the Government's response to the Ombudsman's recommendations against these criteria. It is necessary first to refer to certain key documents.

### *Principles for Remedy and Managing Public Money*

146. In Chapter 14 of her report the Ombudsman refers to the *Principles for Remedy*, which she published in October 2007. In that document the Ombudsman propounded a general principle that:

Where maladministration or poor service has led to injustice or hardship, public bodies should try to offer a remedy that returns the complainant to the position they would have been in otherwise. If that is not possible, the remedy should compensate them appropriately. Remedies should also be offered, where appropriate, to others who have suffered injustice or hardship as a result of the same maladministration or poor service.

147. She identified an appropriate range of remedies, including an apology and "financial compensation for direct or indirect financial loss, loss of opportunity, inconvenience, distress, or any combination of these."
148. The Ombudsman also indicated that "the impact on the individual, for example whether the events contributed to ill-health, or led to prolonged or aggravated injustice or hardship" is among the factors to consider when deciding the level of financial compensation for inconvenience or distress. Her principles are summarised in the Good Practice Guide at the end of the document.
149. The Government has endorsed the Ombudsman's Principles for Remedy. In *Managing Public Money* published in October 2007, the Treasury gave guidance in the following terms:
- 4.12.4 Where public sector organisations fail to meet their standards, or where they fall short of reasonable behaviour in relation to those they do business with, it may be appropriate to consider offering remedies. These can take a variety of forms, including apologies, restitution (eg supplying a missing licence) or in more serious cases financial payments beyond what the law or contract strictly requires. When deciding whether financial remedies might be appropriate, each organisation should consider the legal rights of the other party or parties, the potential effects on its reputation and the impact on its future business.
- 4.12.5 When central government organisations consider making such payments, whether statutory or ex gratia, they should follow the

guidance in annex 4.14, which includes the PHSO's *Principles for Remedy*.

150. The Treasury guidance makes clear that the *Principles for Remedy* should be taken into account. At A.4.14.12 the guidance states:

When a public sector organisation recognises that it needs a scheme for a set of similar or connected claims after maladministration or service failure, it should ensure that the arrangements chosen deal with all potential claimants equitably. It is important that such schemes take into account the Ombudsman's Principles of Good Administration (see annex 4.3). They must be well designed since costs can escalate if a problem turns out to be more extensive than initially expected.

151. See also A.4.14.18, which sets out the Ombudsman's summary of the principles referred to above. The document refers repeatedly to the need to provide a remedy for injustice as a result of maladministration (which is defined as "any form of administrative failing or bad practice"). However, it is to be noted that nowhere does the Treasury Guidance suggest that compensation should not normally be paid where the maladministration consists of regulatory failure.

*The relevance of the findings of the Penrose report*

152. The Response, and various statements made by Government spokesmen, rely on Lord Penrose's conclusion that Equitable Life was "*principally... [the] author of its own misfortunes*". The Response, at [2.9], described this as Lord Penrose's "central" conclusion, although it conceded that he "was also critical of the regulatory system but found that this was a secondary factor."
153. In its report in December 2008 at [41], PASC drew attention to the incomplete nature of this oft-quoted remark:

The Ombudsman has, however, highlighted the full conclusion of Lord Penrose, in which he went on to state that: "the practices of the Society's management could not have been sustained over a material part of the 1990s had there been in place an appropriate regulatory structure adapted to the requirements of a changing industry that happened to manifest themselves in an extreme form in the case of Equitable Life." The Ombudsman continued: "whether or not Lord Penrose was saying that Equitable's management were the villains here, I think he was also saying that if the police—in this case the regulators—had been doing their job properly they would have been caught a lot earlier." It is also apparent that Lord Penrose was unable to consider these issues: "The jurisdiction to adjudicate on regulatory failure in duty is not mine. Even less is it for me to comment on how government should respond if it were to acknowledge that there had been regulatory failure."<sup>7</sup>

154. The Treasury relied on the limitations of Lord Penrose's remit when addressing the Ombudsman in May 2004 on the question whether she should conduct a further investigation. In her letter of

---

<sup>7</sup> Chapter 20 at [84].

20 May 2004, the then Chief Secretary to the Treasury Ruth Kelly said:

Lord Penrose's report presents a narrative of the events at Equitable Life over many years. His purpose was to discover what had led to the situation of the Society as at 31 August 2001 so as to learn lessons for the future. As he makes clear in the postscript to his report he was not seeking to provide answers to the questions of 'who is at fault for the problems encountered by the Society, and who deserves redress as a consequence?' (Chapter 20, paragraph 77). In the foreword to his report he notes that

*"Breach of duty, and the financial consequences of breach, are properly matters for the established courts of justice and for other appropriate tribunals in the financial sector, to be dealt with in accordance with rules of procedure that take account of the interests of parties, typically focused in adversarial terms."* (Foreword, paragraph 9).

We do not, therefore, believe that any investigation seeking to determine whether there had been maladministration resulting in an unremedied injustice can proceed solely on the basis of the narrative set out in the Penrose report. The report does not make findings of fact which it would be open to you simply to adopt. It will, in our view, be necessary, if you decide to undertake such an inquiry, for you to undertake a full investigation by your Office in order to reach your own view on issues of maladministration.

155. Clearly, therefore, Lord Penrose was not addressing the question whether there had been maladministration resulting in injustice. It is also to be noted that the Chief Secretary's letter does not - as a reason for not conducting a further investigation - propound a principle that no compensation might be paid for regulatory failure.

*The relevance of a finding of maladministration to the payment of compensation*

156. In view of the nature of the Government's response to the Ombudsman's recommendation as to compensation, it is necessary to draw attention to the statements of the Chief Secretary made upon publication of the Penrose report on 8 March 2004. Dismissing parallels with Barlow Clowes, the Chief Secretary explained the distinction as follows:

...At the time of Barlow Clowes government compensation was paid but there were three fundamental differences between Barlow Clowes and Equitable Life. First of all, in the case of Barlow Clowes, the company was insolvent. It was not trading any more. People were left with nothing. There was no compensation scheme in place. The Parliamentary Ombudsman had found very clear evidence of maladministration and had recommended compensation. On each count the situation is different with Equitable Life. There has been no finding of maladministration, no recommendation for compensation, the company is still trading and there is a safety net provided in the shape of the Financial Services Compensation Scheme, so I think it is quite wrong to draw parallels between the two." (evidence to Treasury Select Committee 16 March 2004, [Q716])

157. The Chief Secretary made similar statements to the House of Commons on 8 March 2004 (cols. 1259 and 1265). Relying on the Ombudsman's dismissal of the complaints in the first investigation, she said:

She concluded that there was no case for the Government to answer, and that there was no maladministration that led to loss. The fact that hon. Members do not agree with her conclusion does not mean that they should reject it.

158. Again, she did not say, as she could have done if this were the Government's position, that it was not normal policy to pay compensation in the event of regulatory failure.

*The Ombudsman's recommendations*

159. In her report, the Ombudsman explained that before she would recommend compensation, she would "need to be satisfied that those who had complained to me, and those who had been affected in the same way by the same maladministration, had sustained injustice in the form of financial loss as a result of that maladministration" ([23] of Chapter 14). At [26] of Chapter 14 the Ombudsman explained that (in accordance with her *Principles for Remedy*) where financial loss is established she would normally expect it to be remedied in full where that is appropriate. She sets out four considerations: absolute loss, relative loss (which would not have been suffered had the person invested elsewhere), sufficient link to the maladministration and that it would be appropriate in all the circumstances. As to what constitutes a sufficient link, the Ombudsman says:

44 I explained in Chapter 5 of this report that the aim of the system of prudential regulation was to protect the interests of policyholders through the supervision of the affairs of insurance companies, in the manner in which Parliament intended and using the means that Parliament provided.

45 Chapter 10 of this report sets out my findings as to the deficiencies in the way in which that regulation was carried out in this case. My conclusions as to whether injustice resulted from the maladministration, which, in Chapter 11 of this report, I found had occurred, are set out in Chapter 12.

46 It is on that basis that I conclude that there is a direct link between the acts and omissions of the prudential regulators and both the information throughout the period that was before those making savings and investments decisions regarding the Society - and also between those acts and omissions and the public knowledge about the solvency position of the Society in the period on or after 1 May 1999.

47 The prudential regulators, and no one else, were given the functions of scrutinising the returns that the Society submitted and of verifying its solvency position. Those regulators did this with advice and assistance from GAD. No other party can be said to be at fault because those regulators and/or GAD acted with maladministration.

48 I am satisfied that there is a sufficient link between the actions of the prudential regulators and GAD and any relative loss that may be established occurred in individual cases. That also goes for the

opportunities to invest elsewhere than the Society which I have found that complainants have lost.

160. At [138] the Ombudsman set out her “central” recommendation:  
 ...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.
161. She considered that such a scheme would remedy any financial loss and loss of opportunities to invest elsewhere than the Society, and described it as “the most appropriate remedy for the injustice that I have found resulted from maladministration” ([140] of Chapter 14). And she recommended that, in line with the *Principles for Remedy*, the scheme should cover all those who have suffered similar injustice to those who have complained (ibid. [141]). She also noted that any scheme should be independent, transparent and simple (ibid. [149]).

*The Government’s Response*

162. The Government has rejected the Ombudsman’s recommendations. At [5.3] of the Response it asserts that:  
 .... the Ombudsman recognises that maladministration was only one among many contributory factors to the specific losses claimed by those who complained to her.
163. The Response ([5.14]) sets out three “difficult and complex issues that need to be addressed”. The succeeding paragraphs set out these issues in the following terms before reaching a conclusion:
- 5.15 **Firstly**, the Ombudsman was only able within her remit to consider the role of the regulator and not the role and responsibility of Equitable Life and other parties. The Penrose Report, which had a wider remit, did set out a series of failings on the part of the Society.
- 5.16 As the Public Administration Select Committee said in their report, “The current board of Equitable Life and many others have acknowledged the legitimacy of Lord Penrose’s conclusion; few people dispute that its former management were primarily to blame.” The Committee concluded, whilst supporting the Ombudsman’s recommendation, that it would not be fair on taxpayers for public funds to pay for losses that are fairly attributable to the market or the former management of Equitable Life.
- 5.17 **Secondly**, as the Ombudsman herself has said, the Government also has a responsibility to taxpayers generally to balance competing demands on the public purse. Her Report states, “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.”
- 5.18 The Public Administration Select Committee also said, “The decision to compensate must not, however, be the equivalent of signing a blank cheque on taxpayers’ behalf.”
- 5.19 It is important to note that neither the Ombudsman nor the Government has been able to estimate the cost of the Ombudsman’s recommendation, as it does not have detailed information on the

relative losses experienced by different groups of policyholders, nor on the factors affecting the losses of different groups.

5.20 **Thirdly**, Parliament has accepted that it is not generally appropriate to pay compensation even where there is regulatory failure. The responsibility to minimise risks and to prevent problems occurring in a particular financial institution lies, first and foremost, with the people who own and run that institution. It would have serious repercussions for the nature and practice of regulation and the relationship between governments and financial markets were the taxpayer to provide a remedy for all losses whenever financial institutions fail and maladministration by the regulator was found.

5.21 **Therefore, for the above reasons**, the Government does not accept that it would be appropriate to establish a compensation scheme in the way the Ombudsman has recommended. However, the Government does believe that government action is justified in this case. (emphasis added)

164. In [5.22] the Government indicates that “the representations it has received suggest that there has been a disproportionate impact on some Equitable Life policyholders. **To that extent**, the Government believes that some ex gratia payments will be warranted” (emphasis added). At [5.23] the Government indicates that payments “must also take account of the extent to which losses suffered by policyholders were the result of the maladministration which has been accepted, or can be attributed to other factors such as the conduct of Equitable itself.”

165. At 5.26 the Government sets out the remit of Sir John Chadwick to advise it on

- The extent of relative loss
- Apportionment between maladministration accepted by the Government and actions of others
- The classes of policyholders who have suffered the greatest impact
- “what factors arising from this work the Government might wish to take into account when reaching a final view on determining whether disproportionate impact has been suffered. The Government will consider Sir John’s advice on the relevant factors before setting the criteria for the payment scheme.”

166. The Response indicates that Sir John Chadwick does not have to receive representations, although the Government has reserved the right to make representations to him. Thus:

1.14 The Government’s response to the Ombudsman’s findings and her recommendations in no way implies that Equitable Life was without fault. The Government reserves the right to make representations on this issue during the Rt Hon Sir John Chadwick’s consideration of matters relevant to disproportionate impact suffered by current and former Equitable Life policyholders.

(and see 4.3 to similar effect).

167. In paragraph 12 of your letter of 19 February 2009 you say that the decision whether to receive representations, including those from the Government, will be one for Sir John Chadwick; and that the Government will make representations if Sir John Chadwick does invite them from interested parties. Is it the case that the Government will not make representations unless other parties are invited to do so? The Treasury's Memorandum to PASC of 6 March 2009 confirms (at [57], under the heading "Oral representations") that Sir John Chadwick will be seeking written representations. You have not answered our question whether interested parties will have an opportunity to see and respond to any representations which the Government makes to Sir John Chadwick.
168. The Government's alternative proposal may be criticised on a number of grounds.
- Limiting payments to those who have suffered "disproportionate impact"*
169. It appears from [5.22] of the Response that the Government proposes to make ex gratia payments only to those who have suffered "disproportionate impact". This appears to frustrate legitimate expectations, to treat differently those who are similarly placed and to be irrational.
170. **Legitimate expectation:** the Ombudsman's proposed remedy is in accordance with her *Principles of Good Administration* and *Principles for Remedy*: see paragraph 146 above.
171. This should include financial compensation for direct or indirect financial loss, loss of opportunity, inconvenience, distress or any combination of these. The impact on the individual may be considered in assessing the level of compensation for inconvenience or distress.
172. *Managing Public Money* enjoins public authorities to "follow the guidance" in annex 4.14, which includes the Ombudsman's *Principles for Remedy*. The Treasury Guidance also makes clear that public authorities should ensure that the arrangements chosen deal with all potential claimants equitably. Members of the public are entitled to expect that the Government will adhere to the principles which it has endorsed and directed itself to follow.
173. The normal rule, as set out in the *Principles* and adopted by *Managing Public Money* is that
- a. where there has been injustice as a result of a failing by a public body, this should be remedied by putting the individual back in the position that they would have been in but for the failing, or compensating them if the position cannot be restored;
  - b. all those similarly placed should be treated equally, without making arbitrary distinctions;
  - c. the impact on an individual is relevant to the assessment of the level of compensation for inconvenience or distress.

174. The legitimate expectation is born out by past practice in response to reports of the Ombudsman and by the Government's response to calls for the payment of compensation to Equitable policyholders following publication of the Penrose report. Members of Parliament sought to draw parallels with the Government's response to the Ombudsman's report into the Barlow Clowes affair. As appears from the Chief Secretary's statement set out at paragraph 156 above, chief among the distinctions between the two cases, and the reasons for not paying compensation in the case of the Equitable, were that:

The Parliamentary Ombudsman had found very clear evidence of maladministration and had recommended compensation. On each count the situation is different with Equitable Life. There has been no finding of maladministration, no recommendation for compensation...

175. The clear implication to be drawn from this is that the Government's response would have been different had there been a finding of maladministration and a recommendation of compensation. Again, members of the public are entitled to expect the Government to act consistently with its earlier statements in the very case in which those statements were made. In this respect we also note that the Chief Secretary's letter to the Ombudsman dated 20 May 2004 (which addressed the question whether the Ombudsman should conduct a further investigation) gave no suggestion that the Government would seek to limit the payment of compensation which the Ombudsman might recommend if her investigation determined that there had been maladministration resulting in an unremedied injustice. One of the factors which the Ombudsman was considering at that time - as the Government knew - was whether a further investigation by her Office would be likely to provide a worthwhile outcome.

176. The Government has not announced any change of policy, nor has it identified any overriding interest which would justify departure from its existing policy. While considerations of affordability might affect the level of compensation payable, they do not justify a departure from the principles which the Government has adopted. The Government's proposals do not comply with these principles: they seek to limit payments to those who have suffered "disproportionate impact" and, as indicated above, by reference to a "principle" that payment should not be made for regulatory failure.

177. **Arbitrary discrimination:** the Government's approach will treat differently those who are similarly placed. The Ombudsman has clearly identified the basis on which she found injustice. The Government's approach will discriminate between those who have suffered loss by singling out particular groups of policyholders for *ex gratia compensation* while denying it to others. Formal equality, or consistency, is fundamental to the rule of law, so that treating like cases alike and unlike cases differently is a general axiom of rational behaviour. If distinctions are to be drawn, this may be done only on a rational basis.

178. The Government has not identified any rational basis on which to discriminate between different groups of those who have suffered loss. The Response says that the representations the Government has received suggest that there has been a disproportionate impact on some Equitable Life policyholders. The content of those representations has not been made public. **We shall be grateful if you will disclose them to us.**

179. Moreover, Ministers have been unable to explain, even in the most general terms, what they understand by “disproportionate impact”. The Minister was questioned about this repeatedly when he appeared before PASC on 11 February 2009. The following exchange exemplifies, in our view, the fact that the Government cannot identify any content to the supposed principle of disproportionate impact:

**Q 141 Chairman:** It would have been possible to compensate everybody who had suffered a loss, a loss arising from regulatory failure as demonstrated by the Ombudsman - that would have been a proposition, but that proposition you have rejected and you are not going to do that; you are going to compensate some people on an *ex gratia* basis and those people are in this category of disproportionate impact. What I am trying to find out is, given all that, whether you know, whether the Treasury knows what that category is because we have had difficulty in identifying this as we have been going along.

**Ian Pearson:** If we knew the answer we would not ask Sir John to do the work.

**Q 142 Chairman:** No, but you have said that there is a category and presumably you have had enough evidence to suggest that there is a category otherwise you would not have announced it.

**Ian Pearson:** What we have said is that there are a number of factors that need to be taken into account when discussing whether disproportionate impact might have occurred and we need Sir John to look at those and to advise us.

180. It is not clear what the impact is meant to be disproportionate to. The Response says that the Government is instructing Sir John Chadwick to advise on the factors which “the Government might wish to take into account when reaching a final view on determining whether disproportionate impact has been suffered”. However, in deciding to ask Sir John Chadwick to advise, the Government must have some notion of what the phrase means in order even to justify its embarking on the exercise. At the moment, we can discern no principle on which the Government seeks to discriminate between different groups of people who are equally affected by the maladministration which there has been.

181. In her first Memorandum to PASC, the Ombudsman said of this at [35]:

... no definition has been provided of the concept of ‘disproportionate impact’ which has been introduced by the Government in its response to my report. Given the centrality of it to the work now to be done, I am surprised that no attempt has been made to give a clearer picture to those affected as to the basis on which Sir John will undertake his work.

*Compensation for regulatory failure*

182. At [5.20], the Response indicates, as one of the reasons for not accepting the Ombudsman's recommendation, that "Parliament has accepted that it is not generally appropriate to pay compensation even where there is regulatory failure." The reasons cited are set out in the full citation at paragraph 163 above. This is, in our view, an irrelevant consideration, and one which frustrates the scheme of the Parliamentary Commissioner Act 1967. In any event, it is a consideration which the Government could have raised, but did not raise, in May 2004 when the Ombudsman consulted about whether to conduct a further investigation.
183. The Response sets out, in very short form, a line of reasoning which the public bodies advanced to the Ombudsman in the extensive submissions which they made to her about this matter, which are set out in Chapter 14, [53] - [66].
184. The Ombudsman dealt with these submissions at considerable lengths at [68] - [88]. She characterised the submissions as "surprising" [68], for three reasons:
- a. they invited the Ombudsman to adopt a blanket approach to compensation for financial regulatory failure, which would improperly fetter her discretion [69] - [70];
  - b. the exclusion of compensation in such cases "would constitute a fundamental constitutional principle, one which was not articulated by Parliament within the legislative framework which governs my role" [71]. Parliament could have excluded or limited her powers in such cases, but did not do so. [71] - [80];
  - c. At no time until receiving the draft report did the Government advance any principle that compensation should not be paid for regulatory failure. She concluded at [87] that complainants "have a legitimate expectation that I will consider what it would be appropriate to recommend by way of remedy, without imposing constraints which have no grounding in the legislative scheme governing my role". See generally [81] - [88].
185. At [89] ff the Ombudsman considered whether the submissions made by the public bodies nonetheless provided an adequate basis for concluding that no remedy should be forthcoming. She considered the direct analogy which the public bodies sought to draw between maladministration and negligence and concluded at [107] that while there might be a substantial element of overlap, the concepts are not synonymous. She continued:
- 108 There is no reason in principle why the considerations which determine whether there has been maladministration should, necessarily, be the same as those which determine whether conduct has been unlawful.
- 109 There is therefore no reason why, when exercising my powers to conduct investigations and to report on complaints of maladministration, that I should necessarily be constrained by the legal

principles which would be applicable were the different task being carried out of determining whether certain conduct is lawful.

This is consistent with the use of the statutory term injustice, which “was used with a view to indicating something wider than is covered by the concept of damage, and also perhaps to avoid the need to delve into questions of causation which might otherwise arise in certain cases” (per Collins J in *R v Commissioner for Local Administration, ex p S* (1999) ELR 102; (1999) COD 126).

186. The Ombudsman then went on to consider the public policy reasons advanced by the public bodies - set out at [57] - for not providing financial recompense. She accepted that the public purse is a relevant consideration ([114]) and that the courts have not generally imposed a common law duty of care on regulators ([115]). She explained that the public policy considerations advanced did not apply because the scheme of regulation which she had considered no longer exists [118] and the FSA, which operates the new regulatory regime, is not within her jurisdiction ([120]).
187. In the following paragraphs, the Ombudsman concluded that a recommendation for a financial remedy would be entirely consistent both with the regulatory scheme at the time and with her role and remit prescribed in the 1967 Act. She also explained that the existence of her jurisdiction had been relied on by ministers during the passage of the Insurance Companies (Amendment) Act 1973 as a reason for not introducing an appeal procedure.
188. The Ombudsman’s report provides a complete answer to the public bodies’ submissions on this point. The Response simply re-asserts that which had been advanced to the Ombudsman, but does nothing to undermine these conclusions.
189. For the reasons which the Ombudsman gives, the consideration advanced by the Government is irrelevant and would frustrate the scheme of the Parliamentary Commissioner Act 1967. Moreover, in reaching its conclusion, the Government appears to have taken no account of the Ombudsman’s approach to the standard of regulation, which sets a very high threshold of regulatory failure before maladministration is found. Nor does the Response acknowledge that in making findings of maladministration the Ombudsman required not only that there be a departure from the applicable standard of regulation, but that such departure must have been unreasonable in the circumstances.
190. As indicated above, there is nothing in the *Principles for Remedy* or in *Managing Public Money* (which endorses those principles) (see paragraphs 146 ff above) or in the Government’s observations on the Ombudsman’s proposed further investigation (see paragraphs 154 ff above) or its earlier statements as to compensation following the Penrose report (see paragraphs 156 ff above) to suggest that it is not normal policy to pay compensation in the event of regulatory failure. The Economic Secretary to the Treasury was asked by PASC on 11 February 2009 why the Government had not advanced this argument in May 2004. He said that “the Government’s views on compensation were made known to the Ombudsman in 2007 and certainly in 2008.”

However, by this time the Government was considering the Ombudsman's draft report. It was clear to the Government in May 2004, when the Chief Secretary wrote to the Ombudsman (paragraph 154 above), that what the Ombudsman proposed was an "investigation seeking to determine whether there had been maladministration resulting in an unremedied injustice". This was also the principal feature which distinguished it from the investigation that Lord Penrose had conducted. Complainants and potential complainants - who had already waited many years without remedy - were therefore entitled to expect that, absent any contrary statement of principle at the time, the Government would not reject or limit any remedy for injustice by appealing to an alleged principle that it would not compensate for failure by the very bodies which the Ombudsman was proposing to investigate.

*Loss attributable to the actions of Equitable Life and other third parties*

191. The Response refers repeatedly to Lord Penrose's statement that the Society was principally the author of its own misfortune. It also asserts that "maladministration was only one among many contributory factors to the specific losses claimed by those who complained to her" ([5.3]). This has led the Government to its conclusion at [5.15] that "the Ombudsman was only able within her remit to consider the role of the regulator and not the role and responsibility of Equitable Life and other parties. The Penrose Report, which had a wider remit, did set out a series of failings on the part of the Society."
192. The Response relies on this as a reason for not accepting the Ombudsman's recommendation. Instead, it has instructed Sir John Chadwick to advise on:
 

...what proportion of those losses [i.e. relative losses suffered by Equitable policyholders] can be attributed to: (a) the maladministration accepted by the Government; and (b) the actions of Equitable Life and other parties; ([5.26])
193. It is on this matter that the Government "reserves the right to make representations ... at a later date" ([1.14] and [4.3])
194. Sir John Chadwick is being asked to make findings about the extent of injustice caused by maladministration. This is a matter within the Ombudsman's jurisdiction, on which she has made findings that the Government has not rejected.
195. The Ombudsman has made clear her view that the relative losses which she has identified are the consequence of the maladministration that she has found. Where she has considered that there was contributory fault, she so found: see, for example, Chapter 12 at [169] ff.
196. The Ombudsman's finding, set out in [23] and [44] - [48] of Chapter 14 should be conclusive of the matter: see paragraph 159 above. These are findings which the Government has not expressly rejected and, beyond its assertion that the Equitable is the principal

author of its own misfortune, it has not set out any reasons, let alone cogent reasons, for rejecting those findings.

197. The Government's assertion as to contributory fault formed part of the public bodies' submissions to the Ombudsman. One of the public policy reasons advanced by the Government to the Ombudsman for not requiring financial recompense was that such a recommendation would:

"obscure the fact that the immediate and material cause of the loss in this case was Equitable itself, coupled with the combined impact of external factors which were beyond the control of the prudential regulator" (Chapter 14 at [57(d)].

198. In Chapter 14 at [65], the public bodies are recorded as submitting as a "further reason why it would be quite inappropriate to recommend any financial remedy"

... that the root causes of the "losses" suffered by policyholders were changes in financial market conditions and Equitable's loss of discretion to adjust terminal bonus rates as a result of the House of Lords' judgment in the Hyman litigation, coupled with the shortcomings of Equitable itself, its senior management and its Appointed Actuary, whose "central place ... within the regulatory regime" is recognised by [me]...

199. The Ombudsman repeated the submission at [116] and responded to it at [122] in the following terms:

Nor would such a recommendation be designed to remedy losses caused by the Society, as has been suggested by the public bodies. In relation to findings of maladministration leading to injustice, such as I have made in this report, the '*primary wrongdoer*' is the body or bodies which acted with such maladministration, not any third party.

200. The Government has not said that it rejects this conclusion, nor set out any reason which might justify its doing so. Absent cogent reasons for rejecting the Ombudsman's finding on this point, the Government must accept it.

201. Instead, the Government has sought to avoid the finding by indicating that this is a matter on which Sir John Chadwick should be asked to provide an assessment. In giving his advice on this matter, Sir John Chadwick must inevitably reach a view as to the correctness of the Ombudsman's conclusion that the relative losses which she has identified are the responsibility of the regulators and no one else. Moreover he must do so after considering the Government's representations on the matter. The Government cannot now ask Sir John Chadwick to adjudicate on its apparent disagreement with what the Ombudsman has found. Indeed, the Economic Secretary appeared to accept that position when he told PASC on 11 February 2009 that Sir John Chadwick's remit "certainly is not to arbitrate between the Ombudsman and the Government where we have departed from the Ombudsman's findings." (Q147)

202. The Ombudsman commented on this matter in her first Memorandum to PASC at [36]. She said that the Government's response:

... fails to recognise that I have found injustice resulting from maladministration on the part of the prudential regulators. There is no basis for suggesting that any such injustice was caused by the actions of anyone other than those regulators and those acting on their behalf. There is thus no basis on which to assign blame for maladministration on the part of a public body to anyone else; a remedy for injustice resulting from maladministration should be forthcoming from those alone who acted with that maladministration.

*Failure to have regard to EQUI in deciding on the question of remedy*

203. We have set out, at paragraph 36 above, EQUI's recommendation as to remedy. There is nothing in the Response to suggest that Government took any account of this recommendation when deciding what remedy to afford.

*Insufficient reasons for rejecting the Ombudsman's recommendations*

204. Having set out its three "difficult and complex issues", the Government concludes that "[t]herefore, and for the above reasons" it does not accept that it would be appropriate to establish a compensation scheme in the way the Ombudsman has recommended. However, the Response wholly fails to explain why those three considerations (assuming that they are relevant and lawful) justify a departure from the scheme of compensation which is independent, transparent and simple.

*Independence of the judiciary - Sir John Chadwick's appointment*

205. Mr John Newman, the Chairman of EMAG, has sent you a copy of the letter which we wrote to EMAG's board on 9 February setting out our opinion that Sir John Chadwick's appointment to provide legal advice appeared to be incompatible with the terms of the Guide to Judicial Conduct and the independence of the judiciary, which Ministers of the Crown must uphold: section 3(1) of the Constitutional Reform Act 2005.

206. We have read a transcript of the evidence which the Economic Secretary gave to PASC on 11 February 2009. He has told PASC that

When it comes to appointing Sir John Chadwick to conduct the work and the remit that is detailed in the Command Paper, I want to be very clear that we are not asking Sir John Chadwick for legal advice; what we have asked him to do is a piece of work for us that would provide an independent and objective assessment according to the remit that the Committee seeks.

207. We doubt whether what the Economic Secretary has said can be right. Looking at Sir John Chadwick's remit:

- a. The "extent of relative losses suffered by Equitable Life policyholders" seems to be entirely a question of the assessment of quantum. It is to be assumed that Sir John Chadwick is asked to assess quantum on the basis of legal principles of causation and assessment of damage rather than on any other basis. That would appear to be a question of legal advice.

- b. The question of “what proportion of those losses can be attributed to: (a) the maladministration accepted by the Government; and (b) the actions of Equitable Life and other parties” would also appear to be a question which calls for legal advice on principles of causation.
208. The letter from the Ministry of Justice to Mr Newman dated 5 March recognises that “the issues were pre-eminently suitable for consideration by a retired, senior judge”. Paragraph 55 of the Treasury’s Memorandum of 6th March 2009 to PASC indicates that Sir John Chadwick has recruited legal support from his chambers.
209. Moreover, as we have indicated above, the second question appears to invite Sir John Chadwick to advise the Government on a matter - whether the injustice was the result of the maladministration alone - on which the Ombudsman has already made findings which have not been challenged.
210. We consider that the independence of the judiciary is compromised where a serving or former judge is invited to advise the Government in a matter of legal contention such as this. In the present case, the Government has rejected outright a number of findings of maladministration or injustice and it has qualified its acceptance of other findings (in some cases without giving any reasons) in such a way as to reduce their force or impact. Sir John Chadwick is not entitled to exercise his independent judgment as to the propriety of the Government’s rejection or qualifications, but must simply act on them uncritically. The Economic Secretary made clear in his evidence to PASC that “[i]t is not in Sir John’s remit to provide legal advice or commentary” on whether he considered that the Ombudsman’s argument was better than the Government’s (see Q96). The Ministry of Justice’s letter of 5 March does not meet this objection.
211. Throughout his evidence the Economic Secretary made clear that Sir John Chadwick is undertaking “a piece of work for us that would provide an independent and objective assessment”. He asserted that Sir John Chadwick is neither giving legal advice nor is he formulating policy. That, he said, is a matter for the Government, as [5.33] of the Response makes clear. We are therefore puzzled at the Treasury’s provisional response to our client’s request, under the Freedom of Information Act, for documentation relating to Sir John Chadwick’s appointment and agreement of his terms of reference. In the response, our clients have been told that the information engages exemptions at section 35(1)(a) (formulation of government policy) and section 42 (legal professional privilege). Reliance on these exemptions appears to be inconsistent with the assertions which have been made to PASC.

#### **Documents and information requested**

212. Kindly provide
- a. All actuarial advice received by the Government in relation to the preparation of the Response. We have also asked you to identify the sources of all such advice;

- b. The representations which the Government has received which “suggest that there has been a disproportionate impact on some Equitable Life policyholders”: [5.22] of the Response;
- c. Documentation, previously requested, relating to the appointment of Sir John Chadwick;
- d. Documentation, previously requested, which shows that the Government took the EQUI Report into account when considering its response to the Ombudsman.

#### **Action to take**

213. For the reasons set out in this letter, we invite you to withdraw those parts of the Response set out above and accept the Ombudsman’s findings and her recommendations as to the remedy which should be provided.

#### **Interested parties**

214. We are sending a copy of this letter to the Parliamentary Ombudsman, to the Ministry of Justice and to Sir John Chadwick.

#### **Costs issues - protective costs order**

215. We invite you to agree that in the event that it is necessary to bring proceedings, our clients should have the benefit of a protective costs order in this case. The issues raised are clearly of general public importance, and the public interest requires that they should be resolved. While those that EMAG represents have a private interest in the outcome of the case, this is not to be regarded as a disqualifying factor. Its weight and importance in the overall context should be treated as a flexible element in the judge’s consideration of the issue: *R (Bullmore) v West Hertfordshire Hospitals NHS Trust* [2007] EWHC 1350 (Admin), Lloyd Jones J, approved by the Court of Appeal in *Morgan v Hinton Organics (Wessex) Ltd* [2009] EWCA Civ 107 at [38(iv)], [39] and [40]. Having regard to the financial resources of the claimant and the defendant, and to the amount of costs that are likely to be involved, it is fair and just to make the order in this case.
216. If agreement can be reached in principle, we are happy to discuss the matter with you further.

#### **Time for reply**

217. We require your reply within 14 days of the date of this letter. Claims for judicial review must be made promptly and in any event within 3 months of the date on which the grounds arose. With the intervention of Easter and closure of the Administrative Court Office, we anticipate that should it be necessary to issue proceedings, this will need to be done by 9 April.
218. When we wrote to you on 23 January, we informed you that we were advising our clients on the lawfulness of the Government’s response and needed an early reply as we are anxious to advise our clients promptly. In the event, you did not reply to our letter until 27 February. On 9 February our clients sent you a copy of our letter of advice relating to the appointment of Sir John Chadwick. There

was no reply to the substance of that letter until 6 March, when the Ministry of Justice sent its letter dated 5 March. The Ombudsman's evidence to PASC identified a number of shortcomings in the Government's response to her report. The Treasury's evidence in reply, dated 6 March, was submitted only on 9 March.

219. These delays, together with the volume of material to be considered, have meant that it has not been possible to advise our clients and prepare this letter earlier. However, the time table cannot accommodate any further such delay at this stage. We therefore request your reply within the time limited.

Yours faithfully

*Bindmans LLP*

**BINDMANS LLP**

## Annex A

### Extract from EMAG's initial response to the Ombudsman's report

16 July 2008

#### CHAPTER 1 – THE STORY OF EQUITABLE LIFE

##### THE SOCIETY

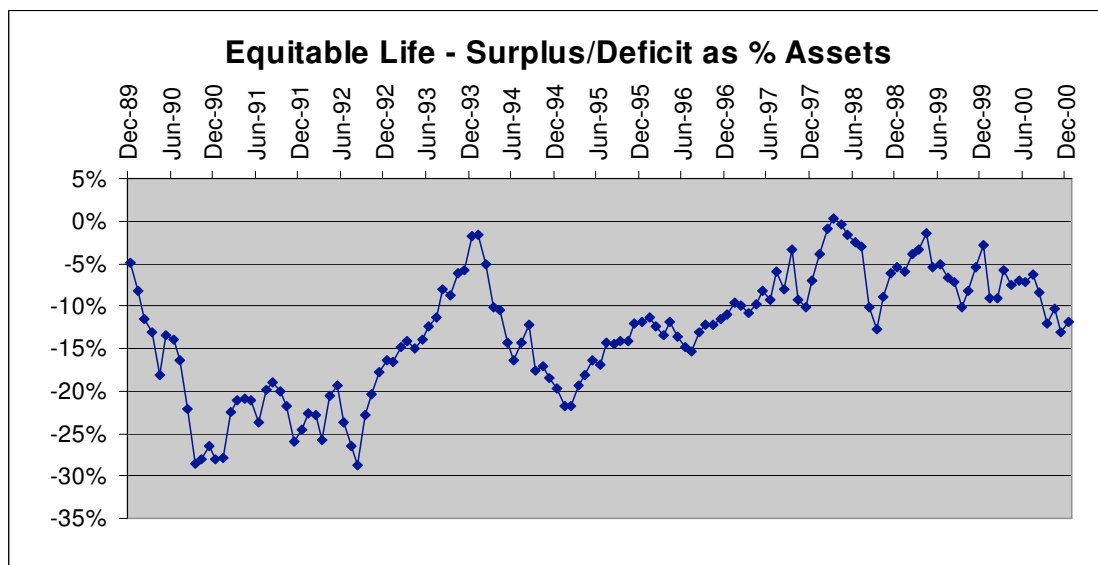
Equitable Life Assurance Society is the world's oldest life assurance company and was famous for not paying commission, low operating costs and (it claimed) fair distribution of profits. The Government Actuary recommended it for public servants including health workers and judges as a suitable home for additional pension investment. But below its respectable exterior in the 1980s / 1990s, under the regime of Actuary Roy Ranson:

- a) It made no provision for the guarantees against low interest rates contained in all policies issued before 1986 (the guaranteed annuity rate or GAR).
- b) It declared bonuses out of all proportion to profits and assets, so far out, that the Institute of Actuaries has expelled Ranson for it (albeit belatedly in 2007). Lord Penrose estimated that the cost in excess bonuses paid out to retiring policyholders in the 1990s was £1,800 million.

Equitable Life's attempt to renege upon its guarantees failed in the House of Lords in July 2000 at an estimated cost of £1,500 million. But the Society had been so weakened by over-bonusing that it could not pay. Indeed it was so weak that no-one would buy its with-profit business at any price. It closed its doors in December 2000 and its directors resigned.

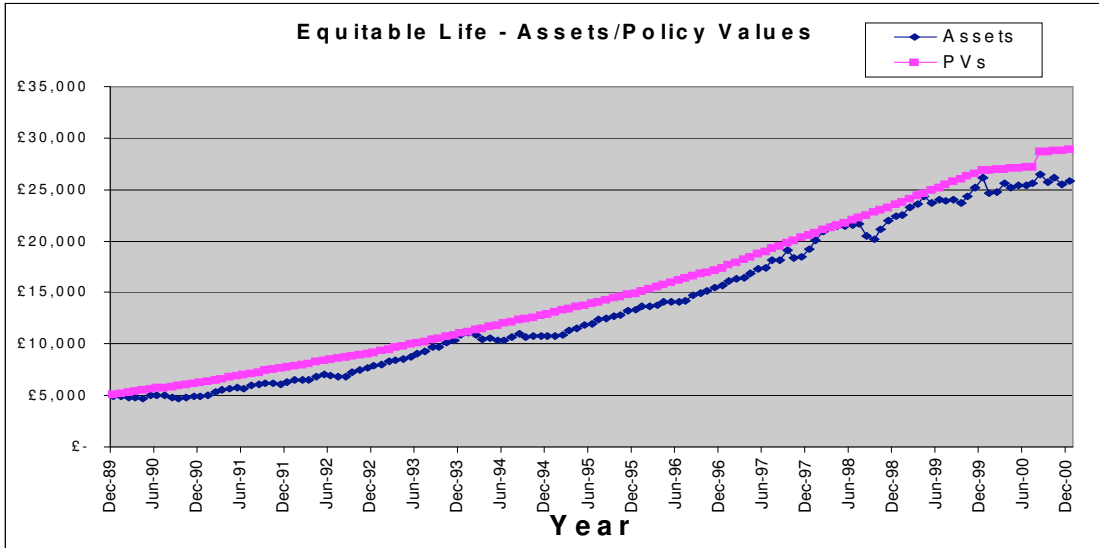
The chart below shows, in percentage terms, how its assets consistently fell short of the aggregate of policy values, which it had indicated to policyholders. The two only came near to being in balance (the 0% line) at times of stock market highs, when there should have been a surplus.

Chart 1



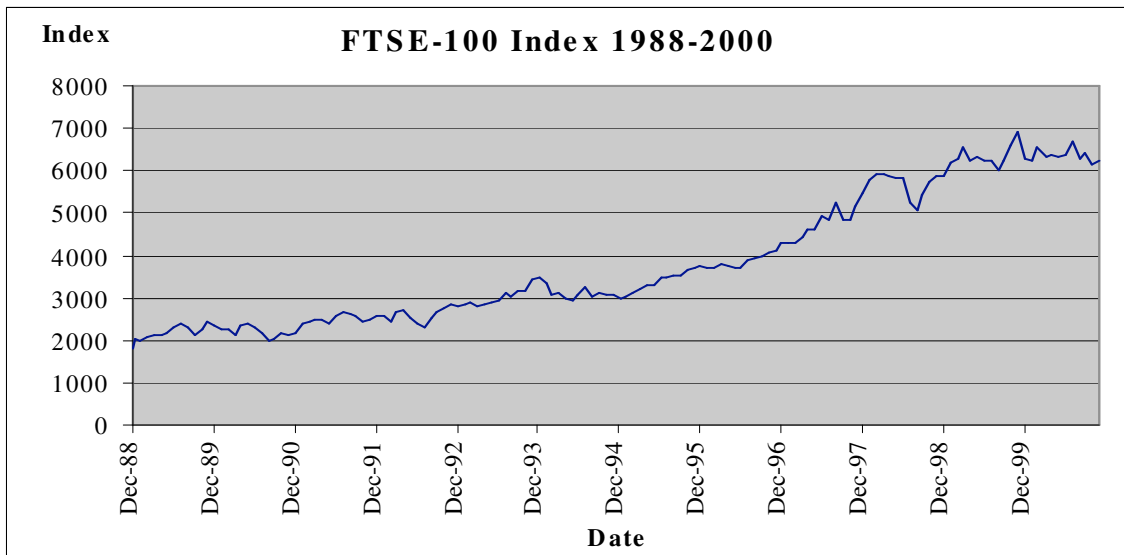
The chart below shows how bonuses voted for 1990, combined with a falling stock market in that year first created a substantial deficit of assets as compared to policy values, running consistently at about £1,000 million over the decade. It also shows the way the Society's with profit business increased six-fold in size.

Chart 2



The final chart shows the FTSE-100 index. The stock market performed well over the decade and was still high when the Society had to close to new business. It was not the cause of Equitable Life's demise. Over the long bull market of the 1990s the Society should (by limiting bonuses) have built up a smoothing fund of surplus assets ready to meet the inevitable down-turn. Instead inflated bonuses continued and at the very peak of the market (FTSE-100 almost 7000 at Dec 1999) it still had a deficit.

Chart 3



In July 2001 the new board of directors slashed policy values by 16% (about £4,000 million) and proceeded to affect a compromise scheme to deal with the GAR problem. However Equitable Life's problems were too deep-seated and this was not enough to enable it to ride out the stock market falls of 2001/2002. In 2002 policy values were cut by another 10% and the Society was forced to invest almost exclusively in fixed interest stocks.

With almost none of its money invested in equity shares, it could not operate as a with-profit insurer and its policyholders did not benefit from the stock market's rise in 2003 to 2007. The Society is now being both run down and broken up. The announcement of the sale of the rump of its with profit business is expected soon.

**FURTHER 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 20,000 members.

We welcome the opportunity to give further evidence to the Public Administration Select Committee on the prudential regulation of Equitable Life, the report of the Parliamentary Ombudsman ("the PO") and the Government's response to that report.

- 2 This submission examines the effect in money and public administration terms of the Government's written response (Command 7538). 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 John Newman MA FCA (Chairman) and Paul Braithwaite (General Secretary) will be giving oral evidence to the Select Committee.

	<b>Contents</b>	<b>Page</b>
	Introduction	1
	Executive Summary	2
	Submission	3-8
	Schedules	9-16

## **EXECUTIVE SUMMARY**

- 4 This memorandum comments briefly upon the Government's response to the Parliamentary Ombudsman's Report, concentrating upon the issues, which affect the quantum of loss and compensation and upon its public administration consequences.
- 5 Our previous submission estimated aggregate policyholder losses at about £4.8 billion and appropriate compensation, after adding exit penalties and interest and allowing various deductions, at £4.6 billion.
- 6 The really big loss/compensation money depends heavily upon the 1991-1996 findings that Equitable Life's regulatory returns, mal-administratively approved by the regulators, were grossly misleading.
- 7 As regards the 'money findings' the Government accepts virtually all the PO's findings of maladministration, but rejects virtually all her determinations that such maladministration led to injustice and where there is no injustice there is no compensation.
- 8 The Treasury proposes to appoint Sir John Chadwick to advise further, but has restricted his instructions so as to consider only those findings which the Government has accepted, eliminating at least 90% of policyholders' losses from his review.
- 9 However fair-minded Sir John Chadwick may be, the Treasury's instructions mean that the resulting compensation will be a very small fraction of the losses incurred by policyholders.
- 10 The 'Chadwick Process' falls a very long way short of the transparent and independent Tribunal recommended by the PO. Sir John Chadwick is a retired Appeal Court Judge, but in this instance he is merely acting as an advisor to the Treasury, itself found guilty, through its sub-contractor the FSA, of 5 counts of maladministration. Sir John owes no duty to Parliament and reports privately to the Treasury. He is not required to hear representations from interested parties. Parliament has no control over the timing of his work. The Government's action is arguably an insult to the Parliamentary Ombudsman and to Parliament.

**THE PO'S FINDINGS**

- 11 The Parliamentary Ombudsman ('PO') made 10 findings of maladministration, but, in order to lead to compensation, maladministration needs to result in 'injustice'. Furthermore, in order for loss / compensation to be substantial, the loss needs to be both significant and applicable to the generality of policyholders. Eliminating the findings which do not meet these criteria leaves what we regard as the PO's 'money' findings:

<b>Table 1</b>		
<b>No</b>	<b>Finding</b>	<b>Injustice</b>
	<b>The unreliability of the Returns</b>	
2 & 4	GAD's failure to question and seek to resolve questions for each year from 1990 to 1993 (Finding 2) and from 1994 to 1996 (Finding 4), related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations	Injustice found, in respect of lost opportunities to invest elsewhere as a result of the misleading returns from 1 July 1991 onwards
3	GAD's failure, when the introduction of the Society's differential terminal bonus policy was identified as part of the scrutiny of the 1993 returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders	
&4	GAD's failure to question and seek to resolve questions ... related to (iv) the holding of no explicit reserves for ... guaranteed annuity rates	
5	GAD's failure ... (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society [i.e. that Standard & Poor's 'AA' rating of Equitable was based upon a misunderstanding of the two valuation methods used.]	
6	<b>Financial Re-Insurance</b> The FSA's failure (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	Injustice found, in respect of financial loss and lost opportunities to invest elsewhere for all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999

**LOSS EVALUATION BASED UPON THE PO'S REPORT**

- 12 Before considering the Government's response, it is important to note the general principle that the earlier findings relating to the unreliability of the Returns are much more valuable in terms of primary loss and compensation than the later ones. The table below shows the loss calculations made based upon the PO's 'money' findings above:

**Table 2**

Investment	Remaining Premium £m <b>A</b>	Total Value £m	Losses to Jan-01 per £10k premium <b>B</b>	Loss from Jul 1991 £m <b>C</b>	Division of Loss £m <b>D</b>
pre 1990	N/A	4,641			
1991	470	1,154	8,692	204 }	
1992	656	1,456	7,517	493 }	
1993	868	1,733	6,254	543 }	
1994	1,016	1,825	5,647	574 }	
1995	1,406	2,302	4,782	672 }	4,446
1996	1,913	2,855	4,080	780 }	
1997	2,437	3,274	2,548	621 }	
1998	2,649	3,200	1,746	463 }	
Jan-Apr 99	860	940	373	96 }	
May-Dec 99	1,721	1,879	747	193 }	
2000	2,108	2,142	768	162 }	355
	<u>16,105</u>	<u>27,401</u>		<u>4,801</u>	<u>4,801</u>

- 13 It will be observed from column B that those who invested with Equitable Life instead of 'elsewhere' in the earlier years lost much more than those who invested later. This is because 'Elsewhere Life':
- a) Did not have Equitable Life's GAR problem
  - b) Was not trying to recover from incoming members excessive bonuses paid to outgoing ones
  - c) Performed better as a result of higher equity exposure.
- 14 It will also be seen that the biggest periods for loss (columns C and D) in money terms are those from 1 July 1991 to 30 April 1999. If findings in respect of those periods, relating to the unreliability of the Returns, were overturned, then the remaining loss, relating to the financial reinsurance finding (from 1 May 1999) would be relatively small, about £355m out of £4,801m or about 7½%.
- 15 In fairness it must be said that late contributors suffered more losses than others in terms of leaving penalties, but the really big loss/compensation money (more than 90%) depends heavily upon the 1991-1996 findings.

**THE GOVERNMENT’S RESPONSE**

- 16 The table below concentrates upon the ‘money’ findings, for which the PO found maladministration leading to injustice and which we have re-grouped under more convenient headings, showing the Government’s response.

**Table 3**

No	Subject	Government Maladministration?	Government Injustice?
2 & 4	<b>Scrutiny of Equitable Life’s returns for 1990 – 1993 (Finding 2) and for 1994 – 1996 (Finding 4)</b>		
	Valuation interest rates	Accept	Reject
	Affordability and sustainability of bonus declarations	Accept	Reject
3	<b>Differential terminal bonus policy (1993 Return)</b>	Accept in Part	Reject
4	Reserves for guaranteed annuity rates	Accept	Accept For 1995 & 1996 only
5	<b>Presentation of Equitable Life’s two valuation results (misleading Standard &amp; Poor’s to rate Equitable ‘AA’) (1995 Return)</b>	Accept in Part	Reject
6	<b>Financial Reinsurance (1998 - 2000 Returns)</b>	Accept	Accept subject to reservations

- 17 It will be observed that the Government accepts virtually all the PO’s findings of maladministration, but rejects virtually all her determinations that such maladministration led to injustice. The above boils down to four issues:
- a) **Valuation interest rates.** Whether the rates used in the valuation of the Society’s mainstream pension business in the returns from 1990 to 1996 inclusive were in accordance with the rules prevailing and whether those rates, if acceptable in themselves, cast material doubt over the sustainability of bonus declarations.
  - b) **GAR Problem.** Whether the regulators should have identified the GAR problem in its examination of the 1993 Return and insisted upon the liability being provided against in that and subsequent returns.
  - c) **Two Valuations.** Whether GAD’s failure to take any action as regards its discovery that Standard & Poor’s had been misled by the Society’s two valuation methods resulted in loss/injustice to policyholders.
  - d) **Financial re-insurance.** Whether the Government’s acceptance of the PO’s financial re-insurance findings is too limited to be significant.
- 18 The above issues, the PO’s findings and the Government’s responses are explained in the Schedules and are summarised in the table below.

**Table 4**

No	PO's Finding	PO on Injustice	Government Response	Loss
2 & 4  3 &4  5	<p><b>The unreliability of the Returns</b></p> <p>GAD's failure to question and seek to resolve questions for each year from 1990 to 1993 (Finding 2) and from 1994 to 1996 (Finding 4), related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations</p> <p>GAD's failure, when the introduction of the Society's differential terminal bonus policy was identified as part of the scrutiny of the 1993 returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders.</p> <p>GAD's failure to question and seek to resolve questions ... related to (iv) the holding of no explicit reserves for ... guaranteed annuity rates</p> <p>GAD's failure ... (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society [i.e. that Standard &amp; Poor's 'AA' rating of Equitable was based upon a misunderstanding]</p>	<p>Injustice found, in respect of lost opportunities to invest elsewhere as a result of the misleading returns from July 1991 onwards.</p>	<p>The Government rejects the PO's findings of injustice.</p> <p>The Government maintains that, if GAD had asked the proper questions, then Equitable Life would have been able to justify its discounting of its mainstream pension business by up to one half and no change in the Returns and no injustice would have resulted.</p> <p>The Government accepts that the regulators should have identified the GAR problem when examining the 1993 Return and that provision for this liability should have been made for 1995 and 1996. Its argument is that the amounts involved did not become sufficiently material to affect policyholders' perceptions until much later.</p> <p>The Government claims that GAD had no duty to inform S&amp;P of their error. It does not explain why GAD continued to use S&amp;P's ratings in its own examinations, its own presentations to Ministers and in replying to questions.</p>	<p>£4,446m</p>
6	<p><b>Financial Re-Insurance</b></p> <p>The FSA's failure (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</p>	<p>Injustice found, in respect of financial loss and lost opportunities to invest elsewhere for all those who joined the Society or paid a further premium that was not contractually required in the period after 1 May 1999.</p>	<p>The Government accepts the PO's finding of injustice, but claims that Equitable Life had other options to allow it to declare a bonus for 1998, without showing an unacceptable solvency position.</p>	<p>£355m</p>

## THE GOVERNMENT'S VERBAL AND WRITTEN STATEMENTS

- 19 In Parliament, on 15<sup>th</sup> January, the Minister provided a verbal apology to policyholders, which on the face of it was unequivocal. The Minister's statement and the brief debate which followed revolved around various issues.
- a) **Relative Losses.** The Minister claimed that Government had not been able to estimate the cost of the Ombudsman's recommendation, based upon the losses sustained by Equitable Life policyholders, relative to how they would have fared by investment elsewhere.
  - b) **The appropriate proportion.** The Minister made much of Lord Penrose's statement that primarily the Society was the author of its own misfortunes. She sought to reduce the Government's contribution to any compensation package by reference to the proportion that the Society and others were to blame.
  - c) **The state of public finances.** The Minister sought to distinguish (and minimise) much-delayed compensation for a decade of regulatory failure in respect of Equitable Life from the immediate full compensation paid to investors in foreign banks, notable Icesave.
  - d) **Disproportionate effect.** The minister acknowledged that some policyholders or groups had been disproportionately affected by the maladministration in respect of Equitable Life. The Minister indicated that any compensation scheme would attempt to provide relief for those disproportionately affected.
- 20 The Minister announced the appointment of Sir John Chadwick to consider and advise upon these matters with a view to creating a 'fair ex gratia payment scheme' for those Equitable Life policyholders who have suffered a disproportionate impact. Those attending and observing the debate might be forgiven for receiving the impression that all those who had been badly affected by the Equitable Life debacle could eventually expect at least some form of compensation. Comment by Members of Parliament was mostly restricted to concerns about the timing of Sir John's advice.
- 21 However, the details of the written response (only published hours after the Minister sat down) make it clear that this impression is far from the truth. The paper, Command 7538, limits both the apology and Sir John Chadwick's consideration to:
- 'Those failures identified in the Ombudsman's report which are accepted in the Government's response' (Apology)
- 'Those accepted cases of maladministration resulting in injustice' (Sir John's instructions)
- 22 It will be observed from the above, that while the Government accepts the PO's findings of maladministration, it mostly rejects her findings of injustice. This eliminates the vast majority of policyholders and the bulk of their losses (not less than nine tenths) from both the apology and from Sir John's considerations.
- 23 Relative Losses and Appropriate Proportion have already been included in EMAG's loss computations. However the Government's descriptions of 'Disproportionate Effect' and 'Public Finances' are too vague to quantify. The best we can say at this stage is that compensation is unlikely to exceed one twentieth of policyholders' actual losses.

## **THE PARLIAMENTARY OMBUDSMAN**

- 24 The Government's rejection of the 'money' findings of injustice is not only a serious attack upon the quantum of policyholders' losses and compensation, but also an attack upon the person and institution of the Parliamentary Ombudsman. She and her team have spent 4 years proving beyond doubt that the Government's regulators failed Equitable Life's policyholders for more than a decade.
- 25 The Ombudsman is the mechanism set up by Parliament to investigate and if appropriate recommend redress for the constituents of Members, who have been harmed by maladministration. If the Government accepts her findings of maladministration, but rejects her findings of injustice and requires expert consideration of responsibility and loss computation, then surely its proper course is to refer these matters back to the PO?
- 26 Sir John Chadwick is a retired Appeal Court Judge, but in this instance he is merely acting as an advisor of the Treasury, itself found guilty through its sub-contractor the FSA, of 5 counts of maladministration. Sir John owes no duty to Parliament and reports privately to the Treasury. He is not required to hear representations from interested parties. Parliament has no control over the timing of his work. The 'Chadwick Process' falls a very long way short of the transparent and independent Tribunal recommended by the PO. The Government's action is arguably an insult to the Parliamentary Ombudsman and to Parliament.

## **CONCLUSIONS**

- 27 As regards the 'money findings' the Government accepts virtually all the PO's findings of maladministration, but rejects virtually all her determinations that such maladministration led to injustice.
- 28 The Treasury seeks to appoint Sir John Chadwick to advise further, but has restricted his instructions so as to consider only those findings which the Government has accepted, eliminating at least 90% of policyholders' losses from his review.
- 29 However fair-minded Sir John Chadwick may be, the Treasury's instructions mean that the resulting compensation will be a very small fraction of the losses incurred by policyholders.

**Equitable Members' Action Group**

**26 Jan 2009**

EMAG is the only substantial Equitable Life policyholder group, with a proper constitution, a money subscription and an elected Board of Directors. It has received subscriptions from over 20,000 policyholders.

General Secretary: Paul Braithwaite, e-mail: [emaqpr@yahoo.com](mailto:emaqpr@yahoo.com)

---

Burgess Hodgson – Chartered Accountants  
Camburgh House, 27 New Dover Road, Canterbury, Kent, CT1 3DN  
Tel: 01227 454627  
Partner: Colin Slater, e-mail: [cds@burgesshodgson.co.uk](mailto:cds@burgesshodgson.co.uk)

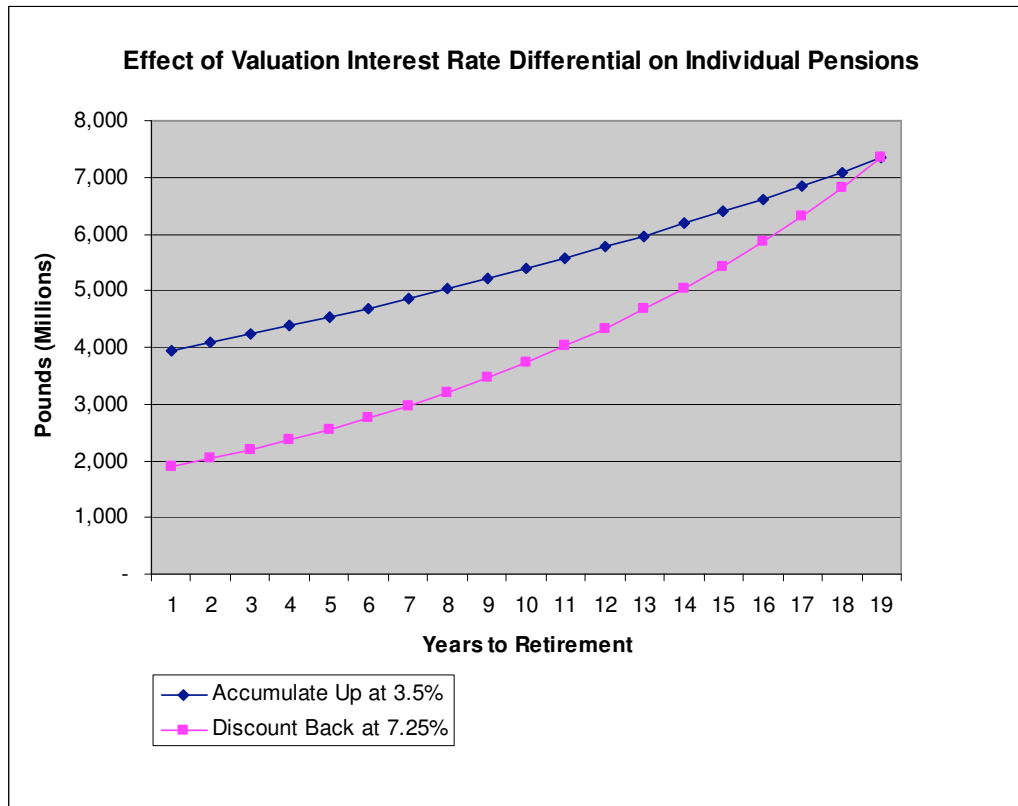
## SCHEDULE 1 - VALUATION INTEREST RATES

Equitable Life's main line of business, representing about 80% of the with-profit fund, was the pension investment policy, that is, the accumulation of premiums during the policyholder's working lifetime to buy an annuity upon retirement. How this line of business was valued was far and away the most important aspect of the annual valuation of liabilities for regulatory purposes. By comparison, other issues should have paled into insignificance.

Policyholders, who received an annual statement showing how much their policy was worth, might reasonably have expected the regulators to use the contractual value shown on those statements (called the 'Guaranteed Policy Fund' or 'GPF'). However this was not the case. Throughout the period 1988 to 1999, the regulators allowed Equitable Life's actuaries to value such policies at a discount from the GPF, sometimes to a very substantial extent.

The largest differential was applied in respect of 1990. The chart below shows, in very simplified form, how the differential of 3.75%p.a applied over 18 years to the average retirement date reduced aggregate guaranteed policy values of just under £4,000m to liabilities for regulatory purposes of £1,900m.

The effect was like telling a policyholder that his guaranteed fund was £4,000, but telling the regulators that the Society only needed assets of £1,900 to cover it.



The PO found that GAD had identified that there was a problem, but failed to ask sufficient questions concerning:

The valuation rate of interest used to discount the liabilities, which appeared to be imprudent and/or impermissible (apparently discounting the liabilities well below the guaranteed face value of policies); and

The affordability and sustainability of the bonuses declared by the Society during this period, which appeared to raise the expectations of the Society's policyholders which, it appeared, could not be met.

The Government accepts this finding of maladministration.

As regards injustice the PO said:

One consequence of this failure was that the prudential regulators and GAD could not be satisfied that the Society was acting prudently and with proper regard to the interests and reasonable expectations of its policyholders. Another consequence of this failure is that the Society was never asked to justify whether it could afford its bonus declarations or how it proposed to sustain the level of bonus that it declared.

She concluded:

I find that injustice was sustained by any policyholder who relied on the information contained in the Society's returns for 1990 to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision as a result of such reliance. Where a policyholder neither relied on this information nor suffered a loss of either type, I find that no injustice resulted from this maladministration.

The Government rejects the PO's determination of injustice. In general terms the Government claims:

- a) that the valuation rates used were within the range allowed by the regulations
- b) that the use of an interest rate differential was allowed by the regulations
- c) that if GAD had raised the matter of sustainability of bonuses, then Equitable Life would have been able 'to establish that its approach to future bonuses was sustainable and affordable'

## **SCHEDULE 2 - THE GAR PROBLEM**

The Society attempted to deal with the Guaranteed Annuity Rate problem in 1993 by means of changing its terminal bonus policy, so that the burden fell mostly upon policyholders instead of on the Society. GAD's failure to follow up the disclosure of the differential terminal bonus policy in the Return for that year meant that it did not discover the extent of the Society's exposure to the GAR problem or the fact that it had made no provision for this liability in its Returns.

The PO found that 'the failure by GAD, when the introduction of the Society's differential terminal bonus policy, intimated within the Society's 1993 returns, was identified by GAD as part of their scrutiny of those returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders constituted maladministration'

The Government only accepts part (i) of the PO's findings.

As regards injustice the PO said:

I consider that the loss of opportunities to take informed decisions about their financial affairs during the period from July 1994 to April 1999 in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated constitutes injustice to policyholders and I consequently make a finding that policyholders suffered such injustice as a result of maladministration.'

The Government rejects the PO's determination of injustice. In short, it contends that even if the regulators had raised the question of the GAR problem, none of the consequences envisaged by the PO would have actually transpired. These included, taking earlier legal advice, testing the policy earlier in the Court and making provision earlier in its Returns. The Government claims that in the absence of regulatory breaches, the influence of the regulators was limited.

As regards explicit reserves for the GAR cost in subsequent periods the PO found: 'that the failure, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to ... (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for ...guaranteed annuity rates, constitutes maladministration by GAD;

As regards 1994, the Government believes interest rates were too low to justify making any reserve, but accepts this finding for 1995 and 1996.

The Government accepts that maladministration led to injustice, but claims that the amounts of the reserve were too small to have shown a significantly different picture. It does not say what, in its view, amounts of the GAR liability would have been.

EMAG's actuary has estimated the GAR liabilities for 1994,1995 and 1996 as £346m, £435m and £483m respectively.

**SCHEDULE 3 - THE TWO VALUATION METHODS**

Equitable Life computed its actuarial liabilities (the value of policies in force) on a 'gross premium' basis in its Published Returns. This was acceptable so long as it could demonstrate that these, in aggregate, showed a higher, more conservative, liability than was required by the 'net premium' method required by the regulations. The Society submitted valuations using both methods, the regulatory version being shown in an Appendix. The resulting totals are shown below in lines A and C. This suggests that the Published version was more conservative than the Appendix one by a substantial margin; what we describe below as the 'Apparent Margin of Prudence'. In fact this was almost entirely illusory, since the Appendix version required a Resilience Reserve, which was not revealed in Returns. Indeed the Returns contained a note which could be read as meaning that no such Reserve was required. After taking into account the Resilience Reserve, the real Margin of Prudence was trivial.

<b>Comparison of Actuarial Liabilities</b>		<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>
<b>Appendix version</b>	<b>A</b>	4,868	6,453	8,079	11,116	12,077
Resilience Reserve (not revealed in Returns)		450	390	462	236	171
	<b>B</b>	<u>5,318</u>	<u>6,843</u>	<u>8,541</u>	<u>11,352</u>	<u>12,248</u>
<b>Published Version</b>	<b>C</b>	<u>5,362</u>	<u>6,852</u>	<u>8,557</u>	<u>11,448</u>	<u>12,378</u>
Apparent Margin of Prudence	<b>C-A</b>	<u>494</u>	<u>399</u>	<u>478</u>	<u>332</u>	<u>301</u>
Real Margin of Prudence	<b>C-B</b>	<u>44</u>	<u>9</u>	<u>16</u>	<u>96</u>	<u>130</u>

For the years 1990 to 1994, GAD asked Equitable to supply to it the Resilience Reserve figure, included in the table above. This meant that GAD could satisfy itself that the valuation method which the Society used was indeed more conservative than that required by the regulations, albeit not by much.

The effect of this charade was that GAD complied with the rules, but allowed Equitable to present to the outside world a misleading impression of conservatism, clearly against the spirit of the 'freedom with publicity' policy advanced by Ministers.

The ratings agency, Standard & Poor's first considered Equitable in 1993, when the Society received an 'AA (Excellent)' rating, which it continued to receive until May 1999. Companies which were given such a rating by Standard & Poor's were described as offering 'excellent financial security'.

It subsequently became clear to GAD that Standard & Poor's had been misled. The PO said:

[S&P's] ratings demonstrated that the Society's method of presenting the two valuations, but without including the figure for the resilience reserve, was being misconstrued.

GAD knew that, contrary to the information contained within Standard & Poor's ratings, Equitable did not adopt a conservative valuation approach – quite the opposite.

GAD also knew that, contrary to the information within those ratings, there was little difference between the results of the Society's alternative method of valuation and the minimum prescribed in the Regulations. In substance, there were no margins, as had been wrongly assumed, between the statutory minimum reserves and the results which the Society's alternative method had produced.

The way in which the Society presented its returns – and was permitted to present its returns – led directly to financial analysts misunderstanding the true financial condition of the Society and to misleading information being disseminated about the 'hidden' strengths of the Society's position. Yet GAD failed to take any action concerning this matter.' Chapter 10, paragraphs 374-377.

She concluded:

'While I accept that the prudential regulators and GAD were not responsible for the content of the ratings produced by such agencies, that does not explain why the Society's ratings – despite them containing assessments which GAD should have known were fundamentally flawed – were used by GAD and by the prudential regulators in a number of contexts – such as in scrutiny reports, as briefing for Ministers and to deal with enquiries as to the strength of the Society.

I consider that GAD should have alerted the prudential regulators to the issue and should have recommended that those ratings should not be used as briefing material and to respond to enquiries.' Chapter 10, paragraphs 393-395.

Her finding was that the failure:

'to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society constitutes maladministration by GAD;'

The Government does not accept that either GAD or the regulator was under any duty to act in response to the credit rating produced by Standard & Poor's.

As regards injustice the PO said:

'That maladministration resulted in the reader of the returns not having the information that was before GAD and which, arguably, should have been available to all readers of the Society's published returns. No action was taken when it was clear that those readers [S&P] were misconstruing the information that was provided. Maladministration also resulted in those who expressed concerns about the Society's solvency being reassured on grounds which were not sustainable.' Chapter 12, paragraphs 34-37.

The Government rejects that any injustice derived from this finding of maladministration. Its reasons are technical justifications for GAD's doing nothing when it ascertained that Standard & Poor's had made a mistake. It does not explain why GAD continued to use their ratings in its own examinations, in its own presentations to Ministers and in replying to questions.

#### **SCHEDULE 4 - FINANCIAL RE-INSURANCE**

This is the most blatant case of maladministration. The Treasury and the FSA bent over backwards to allow Equitable to take £800 million/£1,000 million credit for a reinsurance policy that they knew was worthless. The PO made a finding of maladministration against the FSA. The PO found that this injustice led directly to financial loss.

This finding applies to new policies taken out and new investments made after 1 May 1999. As the bulk of Equitable Life's business was of a single premium type, almost all subsequent premiums totalling about £3,500m are covered by this finding.

This is of particular interest since those who invested after 1 May 1999 got back substantially less than they paid in. Their investments received hardly anything in bonuses (certainly nothing in terms of excess bonuses) and the 16% policy cut was applied to them regardless of that fact. Many suffered further penalties when they tried to mitigate their loss by removing their funds from Equitable.

The PO's finding in this regard has the happy effect of providing a compensation route for those who suffered from other areas of complaint over the same period e.g. the FSA's inaction in respect of the GAR litigation and its failure to demand special consideration for those who joined after the House of Lords decision.

The facts are relatively straightforward.

The Treasury took over prudential regulation from the DTI in 1998 and soon identified Equitable Life as a problem case, particularly as regards its, by that time, serious GAR liability, estimated at £1.6bn. It was clear that inclusion of such a liability in the 1998 Returns would threaten the Society's solvency to the point of putting at risk its 1998 bonus declaration, omission of which was recognised as commercial suicide. A meeting was held with the Society even before that year had ended at which this serious situation was discussed. Re-insurance was mentioned as a possible means of relief. The Treasury expressed its willingness to grant a concession allowing credit to be taken for such re-insurance, even if it could not be actually completed by 31 December 1998.

The FSA took over most aspects of prudential regulation as the Treasury's sub-contractor from January 1999.

The Society then arranged a form of re-insurance with an Irish company for a premium of (initially) £150,000. This was claimed by Equitable Life as an asset worth £800 million. GAD examined the transaction and found it insufficient to justify such a credit. Regardless of GAD's view, the FSA's Director of Insurance and Managing Director told their Board that satisfactory re-insurance cover had been arranged and the Society declared its 1998 bonus in March 1999 in the usual way.

The actual re-insurance treaty was not signed until October 1999 and the Treasury never issued any concession to allow back-dating to 1998. Credit for this treaty was allowed in the 1998 and subsequent returns of the order of £800-1000m.

The PO concluded:

‘that the failures (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 by the FSA;’

As regards injustice the PO said:

I consider that the maladministration relating to the acts and omissions of the FSA in permitting the Society to take the credit that it did for the financial reinsurance arrangement within the Society’s 1998 regulatory returns, which were available to the public by 1 May 1999, constituted a significant turning point. Those acts and omissions represent, in my view, a critical juncture in the sequence of events which I have recounted in this report.

That the Society was permitted by the FSA to take any credit within its 1998 returns, without the required concession, had significant consequences. That was reinforced by the fact that the credit that was taken with the permission of the FSA totalled £809 million – despite the fact that, had regard been had, as it should have been, to the economic substance of the arrangement, no credit would have been permissible at all.

The Society’s 1998 returns were available to the public by 1 May 1999. Had the FSA acted, as they should have done, they would have ensured that the financial reinsurance arrangement was given no credit within those returns, with all the ramifications that this would have had on the reported financial position of the Society.

I consider that, in those circumstances and on the balance of probabilities, if the Society had sought to declare either a reversionary bonus or a terminal bonus in March 1999, the FSA would have taken action to prevent the declaration from taking effect, on the grounds that such a declaration would have adverse effects for the reasonable expectations of the Society’s policyholders if it were later to be reduced.

Any failure to make such a bonus declaration was recognised, at the time, to be ‘commercial suicide’ by both the regulatory bodies and the Society itself. Whether or not in fact the Society did declare a bonus, the Society’s published regulatory solvency position would have been very weak at that point. This would have occurred in a context in which the Society’s serious financial position was not yet generally known to the public.

Once that financial position became known, I consider that many fewer new prospective policyholders, acting reasonably, would have taken out with-profits policies with the Society. The Society’s financial position would have become known shortly after the Society announced, as it would have had to do, that it was not declaring a bonus. If in fact it did declare a bonus, its financial position would have become known by 1 May 1999, when the Society’s 1998 returns were published. I also consider that many fewer existing policyholders would have taken out a with-profits annuity, from which there was no subsequent prospect of exit.

Furthermore, I consider that many fewer existing policyholders would have made further contributions to existing policies in the circumstances which would have prevailed had this maladministration not occurred.

She concluded:

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. Chapter 12, paragraphs 133-146.

The Government accepts the Ombudsman's findings of maladministration and injustice in relation to Equitable Life's use of reinsurance, but seeks to suggest that the consequences would not have been as serious as envisaged by the PO.

The Government claims that Equitable Life had other options to allow it to declare a bonus for 1998, without showing an unacceptable solvency position. These include 'alternative reinsurance cover, adjustment of the margins in Equitable Life's regulatory returns, increased use of the future profits implicit item and reducing some of its equity exposure in favour of fixed interest assets'.

'These options would have impacted on Equitable Life's published solvency position to different degrees, depending on which were utilised and to what degree, and their availability should be taken into account when assessing the impact and nature of the injustice flowing from this finding of maladministration. Recourse to any of these options would also have impacted on Equitable Life's ability to justify to the regulator its ability to pay a bonus in 1999.'

This is an attempt to mitigate the financial consequences to the Treasury of the Government's acceptance of both maladministration and injustice in respect of the Financial Re-Insurance arrangement.