RETURN TO AN ORDER OF THE
HONOURABLE THE HOUSE OF COMMONS DATED
8 MARCH 2004 FOR THE

REPORT OF THE EQUITABLE LIFE INQUIRY

THE RIGHT HONOURABLE
LORD PENROSE

ORDERED BY THE HOUSE OF COMMONS TO BE
PRINTED ON 8 MARCH 2004

VOL 1 of 2

HC 290

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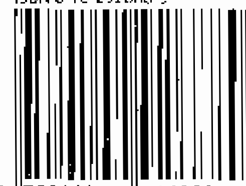

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HC 290 LONDON: THE STATIONERY OFFICE

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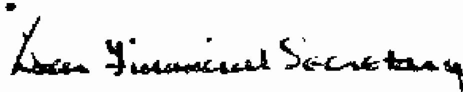
THE EQUITABLE LIFE INQUIRY **Led by the Rt Hon Lord Penrose**

Dorset House, Stamford Street, London SE1 9PY
web-site: www.equitablelife-inquiry.org

From the Rt Hon Lord Penrose

Ruth Kelly MP
Financial Secretary to the Treasury
1 Horseguards Road
LONDON
SW1A 2HQ

23 December 2003



I enclose the report of my inquiry into Equitable Life. You will recall that the terms of reference that you set me on 31 August 2001 were:

> 'To enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury Ministers.'

In your letter of that date you drew attention to the general public concern over that situation, and in approaching the task I have been conscious of the potential significance of my findings.

2. You left it to me to determine how to proceed and what the focus of my inquiries should be. In a case as complex and as important as this one clearly is, I think it was essential that I should be able to approach the task with an open mind as to the main factors giving rise to the situation at Equitable, and how best these matters should be examined. The terms of reference were broad, and the time required to complete this report has inevitably reflected this breadth, as well as the extensive and detailed nature of the available evidence.

3. I was not set a deadline for completion of my inquiry, but I am conscious that the time it has taken has been a matter of frustration for many, not least the large number of policyholders and former policyholders of the Society, many of whom have contacted and contributed to the inquiry. I know that neither you nor I anticipated the required timescale in August 2001, but equally I know that you and your colleagues are as eager as anyone that the necessary lessons are well learnt. The fact that the issues raised are of such potential significance only increased the need for me to approach my task with considerable care. This I have tried to do. However, I regret that it was not possible for me to meet the aim that I set myself last year, and which I informed you and the select committee of last November, which was that I should report in the course of the Summer.

4. The conduct of the inquiry and the procedures I have adopted have reflected its inquisitorial nature and the inherent limitations of an inquiry that has no formal powers. It has also been necessary to avoid competing with the ordinary courts in matters that fall within their jurisdiction. Unfortunately there have been frequent misunderstandings of all of these points. Many of the witnesses, especially those who are engaged in concurrent court proceedings, have sought to treat the inquiry as if it were an adversarial forum, even though it was and could never have been equipped to conduct its proceedings in that way. Some have treated the inquiry as providing an opportunity for rehearsal of the issues that arise or may arise in those concurrent proceedings. Others have expressed frustration that this inquiry could not determine legal liability or adjudicate on the discharge of formal responsibilities. However, I have borne in mind at all times the scope of the litigation initiated by the Society against its former auditors and some of its former directors, as well as the possibility of other legal proceedings, including regulatory and disciplinary proceedings, and tried to maintain a strict focus on finding out and describing how the situation at Equitable came about, without straying into the proper domain of other tribunals that might have an interest.

5. In this last respect, and mindful as I am of the consideration you will be giving to the case for publication of the report, I should mention that I have informed the appropriate public prosecution authorities of aspects of the evidence and my emerging findings.

6. In your letter of 31 August 2001 you also asked me to give due consideration to the fact that the Society was an on-going business and asked me to avoid unnecessary disruption of its current

management. I have done my best to meet this request, subject to the over-riding objective of ensuring that I could properly describe the situation as at 31 August 2001 to which the terms of reference have directed my investigations.

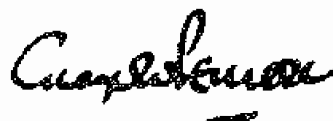
7. It is an inevitable consequence of the nature of this inquiry that the report includes a range of material from a number of different sources. Some of the material is subject to statutory restrictions on its disclosure. In respect of some other material, I have received representations that there may be constraints on its further disclosure owing to subsisting duties of confidence or its commercial sensitivity. These have tended to be at a level of generality that has made identification of specific issues difficult. No clear indication has been given to me of specific information in respect of which a duty of confidence is asserted to subsist. However, throughout the inquiry I have been conscious of the generally confidential nature of much of the material I have recovered. I have given undertakings to some of those providing material that I would have regard to claims of confidentiality, while always making it clear to all parties to the inquiry that the ultimate objective of the inquiry was the submission of a report to Ministers, and that this report would need to fulfil my terms of reference.

8. It is, of course, for Treasury Ministers to determine whether the report should be published in the public interest, notwithstanding any duties of confidence that may subsist in the information contained in it. However, I think that it is important to point out that I have not included material in the report that I do not consider to be necessary to a proper understanding of the evidence and the conclusions that I have drawn from that evidence. Throughout, I have borne in mind the need to take into account and to balance the interests of those with a stake in the report, as well as the various duties and obligations to which I have been subject. I have sought to fulfil the terms of my remit fairly, effectively, and with such expedition as the circumstances permitted. With that in mind, I have sought to include in the report only the information necessary to support the conclusions and the lessons to be learnt.

9. Those that are the subject of criticism have been informed of the gist of the criticism and given the opportunity to make representations in response. I have carefully considered the representations received and taken them into account in finalising my report.

10. As for the findings themselves, I do not wish to add anything to what I have said in the report, and in particular in the last two chapters. Suffice it to say that the issues I have sought to address are complex, and resolving them within the constraints of an inquiry such as this one has not been straightforward. The picture that emerges is of a Society that had deep-seated financial and management problems that pre-dated the emergence of the annuity guarantee problem (though not perhaps its origin). The judgment of the House of Lords in *Hyman* precipitated a crisis, but was not solely responsible for it. The lessons that emerge are broad, and relate to the responsibilities of all the main parties concerned, directors, management, auditors and regulators, but also highlight some important points about the nature of a mutual with-profits fund. There are no simple answers to questions of who lost and who is to blame, as I make clear in my postscript to chapter 20, but it is clear that the situation that was allowed to develop at Equitable has led to hardship and distress to many innocent parties.

11. It is important to provide the necessary powers and remedies to avoid the sort of widespread adverse impact that this case has had, and I am hopeful that many of the proposals being developed by the FSA are addressed towards the right issues. But a clear message from the report should be that it is also important to ensure that the continued relevance of the regulatory tools is regularly assessed in light of a constantly developing industry, and to ensure that those tools are diligently and intelligently applied. The task of regulation must not be allowed to obscure its aim, as appears to me to have happened in this case.



Lord Penrose

REPORT OF THE EQUITABLE LIFE INQUIRY

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FOREWORD

1. At the end of 1993 the Equitable Life Assurance Society put into effect what was to become known as the differential terminal bonus policy. Annuity guarantees incorporated in certain products written before 1 July 1988 had become valuable relative to the current rates available on comparable later products. The differential terminal bonus policy was applied when the policyholder claimed the benefit of the contractual guarantee, and operated to relate the annuity provided to the higher of the equivalent current annuity and the guaranteed rate applied to aggregate guaranteed 'cash fund' benefits.

2. On 20 July 2000 the House of Lords held that the differential terminal bonus policy was unlawful. The directors immediately announced that they were putting the 240 year old mutual society up for sale. The independence and mutual status of the Society, proudly claimed to be the world's oldest mutual life assurance society[1], had previously been vigorously defended by the Board. The decision to bring it to an end reflected a major set-back for the Board. The Board immediately suspended final bonus pending a review of rates.

3. On 2 August 2000, it was intimated that no growth would be allocated on with-profits policies for the first seven months of 2000, to retain within the fund the approximate cost of £1½ billion then estimated to reflect the aggregate value of policyholders' annuity guarantee rights. A financial adjustment, related to final bonus, but representing approximately 5% of policy values, for non-contractual termination of with-profits policies, previously an occasional and discretionary adjustment, was introduced generally[2].

4. Five months later, on 8 December 2000 the Society announced that it had not succeeded in finding a buyer and was closing to new business[3]. The non-executive directors announced their intentions to resign when replacements had been appointed. It was announced that the loss of growth for the first 7 months of 2001 was unlikely to be restored. The financial adjustment was raised to 10% of policy values. It was subsequently raised to 15%.

5. Seven months after that, on 16 July 2001, a new Board announced a 16% cut in the value of with-profits pension policies (14% for with-profits life assurance policies), and in addition intimated that, with the exception of contractual guarantees, no growth would be allocated for the period from 1 January to 30 June 2001. The financial adjustment was reduced to 7½%. The cut in policy values was necessary, and could not be delayed, because, as the Board explained the position, maturity values significantly exceeded the value of the investments underlying maturing policies at the time, stock markets had fallen heavily over the last eighteen months, and a large number of policyholders were taking their benefits.

---

[1] The Scottish Churches and Universities Widows' and Orphans Fund, established in terms of 17 Geo II cap 11 in 1743 may have a prior claim to that honour: *The Scottish Ministers' Widows' Fund 1743 1993 ed. Rev A Ian Dunlop.*

[2] In January 1995 the Society imposed a financial adjustment of 15% of policy values at 31 December 1994 on non-contractual surrenders and transfers at a time when there was a major discrepancy between policy values and underlying assets and a risk of transactions indicating selection against the fund. In August 1995 the rate was reduced to 10%. In June 1996 the adjustment was changed in form to a deduction from terminal bonus. The last occasion on which that adjustment was used was March 1997. On 26 July 2000 following the House of Lords' decision in *Hyman* an effective rate of 5% was imposed, increasing to 10% on 8 December that year. On 16 March 2001 the rate rose to 15%. It was reduced to 7.5% on 16 July when the policy value cut was imposed. On 13 September 2001 it rose to 10%.

[3] The Society subsequently announced on 5 February 2001 that Halifax plc had agreed to acquire the operating assets, sales force and non-with-profits parts of the business. Aspects of that deal are discussed in chapter 5.

6. These major events, taking place over a traumatic year for Equitable Life and its policyholders, represent the immediate background to the setting up of this inquiry. The widely debated issue was what had brought this venerable financial institution, with assets of over £30 billion, to a position where it had had to close to new business, put itself up for sale, apply significant market value adjustments, and reduce the apparent value of its in-force policies by just under £5 billion. The inquiry was launched on 31 August 2001 by the then Economic Secretary to the Treasury, Ruth Kelly MP, with the following terms of reference:

> "To enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury Ministers."

7. It was made clear in the letter the Minister sent to me on that day (and published on the Treasury and the inquiry websites) that it was for me to determine how to conduct the inquiry and which particular matters warranted examination. The terms of reference were broad, and I understood that they had been deliberately made so in order not to prejudge the issues under inquiry. However, the Minister also rightly made clear that it would be inappropriate for me to seek to review the decisions taken in the *Hyman* case or in any other way to assume the proper functions of the courts. I was also asked to be mindful of the fact that the Society was an on-going business and that the inquiry should avoid unnecessary disruption of its current management.

8. It was inevitable that hindsight would instruct much of the inquiry's work and many of its findings. I was asked to discover what had led to the situation of the Society at 31 August 2001. In some cases what individuals had understood, what individuals had anticipated, and what individuals had done might form part of that history. But my terms of reference did not require me to form and express views on what ought to have been understood or ought to have been foreseen, or ought to have been done or omitted, either in absolute terms or relative to the performance or failure to perform duties as director, executive, auditor or professional adviser. I had to have regard to market background where that was material. But it was not for me to measure any person's actions against accepted standards of conduct defining the legal duties of other people performing comparable duties in other organisations and other similar circumstances.

9. I have received representations in the course of the 'maxwellisation' process that has been undertaken that it is unfair, even "grotesquely" unfair, to make criticisms of actions and decisions without comparison with contemporary practice of other institutions or individuals[4]. If I had been required to determine whether any person's conduct was in breach of an obligation owed at the time to the Society or to its policyholders or any class of them, some of the comments I have received from or on behalf of former directors and executives of the Society might have had some substance: I would not have been entitled to form a view whether an act or omission was or involved a breach of duty without taking evidence from others active at the time as to the general scope of the relevant duty and the allegation, from whatever source, that the act or omission was in breach of that duty in the circumstances. However, that was not the remit of my inquiry, as the Economic Secretary's letter made clear. 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 as focused in adversarial terms.

[4] Comments to this effect have been received from individual directors, and, more generally from Allen & Overy on behalf of five directors who refused to co-operate with the inquiry by attending for interview. Allen & Overy's representations were familiar: they essentially reflected their clients' defence in the Society's action that has been sent for trial. These representations have been adopted by others, for whom the solicitors do not appear to act, according to the information provided to me.

10. It would have been unthinkable for an inquiry such as this to have embarked on such a process. I had no powers to compel the production of documents or the attendance of witnesses. I had access to witnesses only by their agreement. The inquiry was not adversarial. There was no mechanism that could have been devised, and put into effect within a time scale that would have had regard to the wider public interest in obtaining the account of the developments of the Society's position, that could have accommodated in parallel the investigation and resolution of disputed contentions of conformity or non-conformity with generally accepted norms of practice in any of the fields that would have been relevant. In the event, co-operation with the inquiry was at best patchy. Several former directors refused to co-operate in any way. Others were constrained by their interests in concurrent litigation from full co-operation. Those who did co-operate could not be subjected to full and searching cross-examination of their comments, even where reliability was questionable because of the witness's focus on making self-serving statements clearly designed to support a position in another forum. The production of documents became a long drawn-out and stressful process as parties' legal advisers sought to protect interests in relation to litigation or threatened litigation and disciplinary proceedings. I am satisfied that I have been able to provide an account of what happened, and in some cases to identify individuals or bodies involved in the events. I am not in a position to adjudicate on whether the events involved breach of duty on the part of directors and other officers of the Society.

11. It follows that it is no more appropriate for me to form or express views on representations by industry sources and other third parties that have sought to distinguish the actions and omissions of Equitable's management from practices in other parts of the life industry and to suggest that the Society adopted practices that did not conform to industry norms and were in some respects unique. I have received representations that indicate that accepted practice in the industry would have been a contentious issue in several areas. There will be those who were active in the industry over the material period, and those who currently represent industry interests, who will continue to argue that Equitable' practices were unique. But the competing contentions are irrelevant to what I have been asked to do. Lessons may be learnt alike from unique or idiosyncratic practices tolerated by a system, on the one hand, and from universally accepted practices that hindsight has undermined on the other. I have interpreted the remit and the Economic Secretary's letter as requiring me to focus on the events that explain the Society's fate. It will be for others to consider in an appropriate forum, and in the context of the facts found according to the practice of that forum, whether fault occurred if that should become or, in the case of current litigation, remain a matter of controversy.

12. In considering the approach to adopt to those who have been concerned with the management and regulation of the Society over time, I have had to balance their sensitivity to critical comment, or comment that might imply criticism, against the interests of another constituency: the very large numbers of members of the public who committed their funds to investment in Equitable products. The complaints of those who have alleged that the inquiry's procedures have been unfair, in refusing for example an opportunity for textual review of the draft report, have to be weighed against the interests of the policyholders in learning what has been found by the inquiry.

13. I have received many representations from policyholders and former policyholders of the Society. I shall later comment on some of them. But it is appropriate at this stage to make some general comments on their position. There is a risk inherent in any analysis of the practices and procedures of a commercial organisation that one may understate the human impact of the events described. That would be a disservice to the many people who have written to their members of Parliament and the inquiry commenting on their experience and providing evidence of their own reactions. One letter will illustrate the position:

> "I write to you in a desperate attempt to get a voice heard in Government to highlight the plight of my wife, myself, and thousands of other hard working,

> honest, contributing members of society. I refer to the victims of the disgraceful EQUITABLE LIFE debacle. It is obvious that the only people who have suffered in this nightmare are the only ones who are innocent of any wrongdoing or negligence; the policy holders.
>
> My wife and I thought that we had done everything right, we ran our own small business, long hours, hard work, put our two children through university all at our own expense and then looked forward to being able to slow down in our latter years.
>
> All this is now in jeopardy.
>
> I request that you please make your voice heard on behalf of all the policy holders and endeavour to see that justice is done, and that politics and blame shifting do not prevail to ruin the retirement hopes of thousands of people who were only trying to make provision for a financially secure and independent old age. After all, it is our money and not a state handout."

14. I cannot adjudicate on the policyholders' complaints and claims: that again is a matter for other proceedings, and the expectation that many have expressed that this report will provide my views on the validity of claims and their value will inevitably be disappointed. But policyholders have a legitimate interest in having as full an explanation as can reasonably be provided of the sequence of events that brought the Society, and them, to their position, and providing that explanation requires that in the presentation of the material I should not shrink from identifying those who were involved with significant decisions or from describing their roles so far as I have been able to identify them. Fairness implies at least giving appropriate weight to competing interests: it is not served by a predisposition to protect from adverse comment those who were involved in the decision-making processes at the time.

15. It was for the inquiry to establish what was the "current situation" as at 31 August 2001, and to identify the circumstances leading to that situation that required explanation, and it was for the inquiry to attempt to interpret those circumstances in order to provide as complete an explanation as possible of what had brought so venerable a British institution so low. Consideration of the current situation at the date of my appointment, and in particular the policy value cuts outlined above, had an immediate and profound impact on my assessment of the factors that were pertinent to this inquiry. Although the annuity guarantees and the differential terminal bonus policy clearly played a significant part in bringing the Equitable Life to the position it was in on 31 August 2001, it was apparent from the outset that annuity guarantees did not answer all the questions. A full consideration of the financial history of the Society going back over many years would be necessary. And as the inquiry has proceeded, I have noted that others have come to the same appreciation of the breadth of the issues involved.

16. However, in the aftermath of these events the annuity guarantee issue was the natural focus of concern, and it has remained the issue most widely believed to lie at the heart of a proper understanding of Equitable's position. The actual position is more complicated, but the annuity guarantees and the *Hyman* case are nevertheless the obvious starting point for any discussion of Equitable's position at 31 August 2001.

<u>Note on Terminology</u>

17. But before I describe how the annuity guarantee issue emerged and came before the Courts, it is necessary to comment on the terminology to be used in this report. As will become apparent from the first chapter, which deals with the origin of the annuity guarantees and the differential terminal bonus policy, the acronym 'GAR' has tended to be applied indiscriminately to all forms of contract. It has also been treated inconsistently, as if it had different meanings in different situations, and sometimes confusion has resulted.

18. The Corley Committee commented on a range of definitions used in its report[5] in relation to Equitable and defined five different terms in the appendix on annuity guarantees. Many of the references to GARs in the documents examined by the inquiry appear to refer to what Corley described as a GAR on a fund value, but in many others the references relate to none of the types described by Corley, but rather to the interest component implicit in the conversion rate applicable at contractual maturity in the Society's retirement annuity and other pre-July 1988 pensions contracts.

19. In this report the general expression 'annuity guarantee' is used in discussion of policyholders' rights under their contracts. The expression 'GAR' is used here to describe the rate of conversion of a cash fund, however computed, into an annuity at maturity. The GAR in this usage invariably comprises two actuarial assumptions, an interest rate and a mortality factor, implicit in the specification of the policyholder's contractual rights from the outset. Quotations and other evidence that appear to ignore the mortality factor have to be treated with caution.

The annuity guarantee issue

20. Problems associated with annuity guarantees affected a wide range of pensions providers in the second half of the 1990s. But there were peculiarities of contractual provisions, implicit rates and other actuarial assumptions, as among providers. The volumes of business affected, both in terms of cash value and as components of the total in-force business of individual offices, varied and that had a bearing on the need to resolve issues and on the policyholder and public reaction to the emerging position. Individual offices varied in the approaches adopted to resolving the problems that arose for them. At one end of the range I have identified an office which had relatively low volumes of annuity guarantee business with implicit interest rates that were considerably lower that Equitable's rates. In common with others, that office implemented the guarantee provisions in full. At the other end of the range there was an office which adopted policies similar to those applied by Equitable in relation to problems of a similar scale. It has subsequently complied with the *Hyman* decision. Equitable's differential terminal bonus policy was identified and publicised by independent commentators, and became controversial. There was open debate in the financial press from the summer of 1998. From July 1998 there was a growing number of complaints to the PIA Ombudsman.

21. In Chapter 1, I shall describe the litigation process more fully. It had its origins in legal advice sought by the Society in September 1998, initially from its retained solicitors and thereafter from counsel, on the validity of the differential terminal bonus policy. The solicitors' initial advice was qualified, but as matters were explored with counsel the advice became more positive and assertive of the validity of the Society's position. Declaratory orders confirming the validity of the Society's policy were sought in the High Court. Alan Hyman was selected by the Society as representative defendant. The Society succeeded at first instance before the Vice Chancellor. The Court of Appeal reversed that decision by a majority. The Society appealed to the House of Lords. There the Society lost comprehensively. Not only was the differential terminal bonus policy held to be unlawful, but the Society's alternative approach, to limiting the consequences of an adverse decision by 'ring-fencing' the annuity guarantee liability so that the burden fell only on those classes of business that had the benefit of the guarantees, was rejected.

22. The issues focused in the originating summons in the *Hyman* case were the subject of protracted discussion between the Society and its legal advisers. There was a desire on the one hand to define the issue for the court as narrowly as possible, with a view to controlling the argument, and on the other hand to limit the risk of future challenge by closing off as many areas of dispute as possible on grounds of issue estoppel. So, ring-fencing was initially referred to in the managing director's affidavit at first instance, but it was not dealt with in the declaratory

[5] Report of the Corley Committee of Inquiry, September 2001, appendix 2 paragraph 2.

orders sought. Once the issue had arisen in debate in the Court of Appeal it increased in importance. It became a significant issue in the House of Lords after counsel's intention to argue in that court primarily on grounds based on the fundamentals of mutuality was frustrated by her discovery that the Society's practices had been inconsistent with the argument she intended to advance.

23. There was nothing casual about the preparation of the pleadings and supporting evidence, nor about the specification of the issues for resolution by the court. The *Hyman* case was carefully planned. The restriction of the issues, and of the range of representative defendants, ultimately to a single individual, were decisions taken after debate. Similarly the restriction of the class of business to retirement annuity and similar contracts reflected a decision to avoid discussion of other product types that incorporated guarantees that the Society dealt with by the differential terminal bonus policy. I shall discuss the background more fully, but I wish to emphasise that, however one might disagree with the views expressed and conclusions reached, in my view the decision to embark on litigation is not open to criticism.

PART I: ANNUITY GUARANTEES

CHAPTER 1: ANNUITY GUARANTEES AND THE *HYMAN* CASE

1. The first of the key events referred to in the foreword as giving rise to this inquiry was the judgment of the House of Lords in the case of *Hyman* v *Equitable Life*, which was delivered on 20 July 2000. The Appellate Committee held that the differential terminal bonus policy pursued by the Society was unlawful. Later in this report I will discuss the other two key events, the closure to new business and the with-profits policy value cuts, but the starting point must be the annuity guarantee issue. In the aftermath of the decision, it was the natural focus of concern, and it remains the issue that is widely viewed as lying at the heart of these later events. As I will come on to describe, the position is more complicated than that, but the annuity guarantees provide the obvious starting point for any discussion of the Society's position at 31 August 2001. Whatever else contributed to the situation at Equitable Life, the annuity guarantees had a part in it.

2. In brief, the commonly understood version of events runs as follows. From the 1950s to the 1980s the Society sold retirement annuity policies that included a guarantee of the annuity payable in respect of contributions, with provision for bonus additions. The rates were guaranteed for subsequent contributions as they were for the initial contribution that the policyholder contracted to make. From 1973 the Society allocated, in addition to guaranteed reversionary bonuses, a non-guaranteed terminal (later final) bonus that accrued notionally over the duration of the policy.

3. For most of the relevant period current immediate annuity rates exceeded by a clear margin the guaranteed rates under the policies, of whatever generation. The Society in those circumstances paid the higher benefits. Towards the end of 1993 interest rates fell, and the balance swung briefly in favour of the annuity guarantees. After an upswing in interest rates, the rates fell again and from 1995 onwards the annuity guarantees provided a higher rate of return. The Society sought to recover the cost of meeting the annuity guarantees, where claimed, by reducing what would otherwise have been the policyholder's final bonus. This ensured that the guaranteed annuity payable was equal to the annuity that would have been paid at current annuity rates on full fund value, including terminal bonus. This was subject always to the Society's admitted obligation to pay the guaranteed rate on the accumulated guaranteed benefits accrued to the date of the claim.

4. The Society implemented its policy, convinced that it thereby ensured equity between the two broad policy classes, those with guarantees and those without. The decision of the House of Lords caused a material transfer of economic benefit from policyholders who had the benefit of annuity guarantees to those who did not. It amounted to an additional liability that had not been acknowledged previously and affected the Society's financial position. It forced the Board to seek a buyer for the Society's business.

5. In this chapter I will describe how the annuity guarantee issue emerged and was understood within Equitable, how the *Hyman* litigation was initiated and conducted, and the contingency planning that was done by the Society in the course of that litigation. In the next chapter I will consider the forms that the guarantees took, the reasons for writing them in the first place, and for removing them later on. I will also explore the origin of the differential terminal bonus policy that was at the heart of the *Hyman* case.

Emergence of the Annuity Guarantee Issue

6. The financial position of Equitable, and the conduct of its with-profits business, came under close public scrutiny in and after 1998. Before that there was concern on the part of certain IFAs about the Society's position, in some cases as early as 1993. The Society's annuity guarantees were the focus of the *Hyman* litigation. Alan Hyman was not the first policyholder to challenge the Society's position on annuity guarantees. There were some settlements with policyholders who objected to the practice before 1998. Complaints began to be intimated to the PIA Ombudsman in July 1998. Hyman had been an Equitable policyholder for some time and held a number of policies incorporating annuity guarantees. He began to consider changing his pension arrangements in the Autumn of 1998. By then the Society's treatment of policyholders with such guarantees had become controversial.

7. Annuity guarantees emerged as a general issue for the life assurance industry following the take-over of Crusader Insurance by Sun Life of Canada. Sun Life made a provision of £140m to cover guarantees contained in policies it had inherited as a result of the acquisition. Stuart Bayliss of Annuity Direct, an independent financial adviser, identified a similar issue in the case of Equitable. He made public his view that the Society's approach to maturities on contracts incorporating annuity guarantees was not in line with the provisions of the policy documents or the illustrations the Society had provided to policyholders and prospective policyholders. Media interest followed.

8. The risk of general conflict with the Society's annuity guarantee policyholders was raised internally in a paper prepared for the product investigation team (PIT) meeting on 2 April 1998 by Chris Matthews, the assistant general manager responsible for running the actuarial projects department (APD). This was not the first time that the potential for conflict had been identified, however. Towards the end of 1993, probably prompted by a policyholder complaint, an actuary in Matthews' APD team, Andrew Soundy, discussed falling interest rates with Matthews, and, as a result, Soundy became aware of the Society's approach to dealing with the problem.

9. As will be described in more detail in the next chapter, Soundy approached Roy Ranson, the chief executive and actuary, and was set a project to propose alternatives. On 29 November 1993 he sent Ranson an initial memorandum, suggesting that the Society's approach might be thought underhand, followed up by more ample proposals. He suggested ring-fencing the additional liabilities within the annuity guarantee classes. Chris Headdon, who was at that time the executive assistant actuary responsible for valuation, responded, challenging this approach. A meeting followed between Ranson and Headdon on the one hand and Soundy on the other. Soundy made no progress against the two more senior actuaries. But he had warned of the risk of inequity and reputational damage in the Society's proposed approach.

10. When the issue arose again in April 1998, Matthews referred to the practice that had obtained of incorporating an 'annuity rate guarantee' in most of the Society's recurrent single premium with-profits pension contracts written up to July 1988. He drew attention to the fact that, in current financial circumstances, the annuity rate arising from these provisions was relatively generous and, with improving mortality, and a generally low interest rate climate, could be up to 20% higher than the Society's current annuity rates.

11. Matthews reported that the Society's stance, when challenged on its treatment of annuity guarantee policyholders, had been to state that the proceeds of the policy would comprise at least the product of the sum of the contractual guaranteed benefits and declared reversionary bonuses accrued times the guaranteed annuity rate. Final bonus would be adjusted to take account of the cost of providing the guarantee. He pointed to two problems with that approach:

- policyholders had received annual statements showing the full fund value, subject to an explanatory note about guaranteed annuity rates; and
- past illustrations had shown the full fund value applied equally both to guaranteed and contemporary current annuity rates.

He identified a risk that the Society would come under greater pressure on the subject. He referred to media interest. He invited discussion, and proposed three approaches that the Society might take:

- continue with the existing policy and risk a case ultimately landing up in court;
- concede on a case by case basis if it were felt that the client had a strong enough case based on misinformation in the past;
- recognise that there was a problem for particular (identifiable) policy classes and have reduced bonus rates for such classes.

12. It is clear from Soundy's statement to the inquiry and the contemporary correspondence that by April 1998 the issue was not novel. By that date there was a developed stance to adopt in the face of challenge, and a range of possible responses had been identified. The notes of the PIT meeting recorded that it was agreed that the Society would continue to defend its approach but, as a last resort and only if approved by APD, would apply guaranteed annuity rates to the full fund value as a gesture of goodwill. So far as the PIT was concerned, the general policy line could be held, and settlements reached on an ad hoc basis. It was agreed that the wording of policyholders' annual benefits statements would be reviewed. The memoranda recording PIT meetings were circulated among senior management of the Society.

13. The PIT discussed the revision of the annual statement of benefits thereafter, but on 26 August 1998 the team returned to the annuity guarantee issue more generally. The Society's confidence in its approach was affirmed. A field force circular was to be distributed. On 28 August 1998, Headdon, by then the appointed actuary, distributed an internal memorandum on the emerging issue to staff. He stated that annuity guarantees had last been written in 1988, and that the Society could identify the affected policies. The Society's practice of treating all pensions business as primarily providing a cash fund at retirement, which was by then widely known, was rehearsed. He set out the approach to the relevant business as follows:

> "Where a policy contains guaranteed annuity rates, those provide an alternative form of the guaranteed benefits, i.e. in annuity rather than cash fund form. If, over the years, the basic guarantees had been expressed in annuity rather than cash fund form, different final bonus rates would have applied reflecting the different nature of the guaranteed benefits. In recent years, the Board has determined that, where an annuity is taken on guaranteed terms and the guaranteed annuity rate is higher than the equivalent current annuity rate, the final bonus is lower than would apply if the benefits were taken in cash fund form. For the last few years, as interest rates have fallen and it has become more likely that a guaranteed annuity rate would be higher than the equivalent current annuity rate, a note has been added to relevant annual statements describing that position.
>
> To confirm, the practical operation of a guaranteed annuity rate in the Society's case is that the annuity payable is the greater of
>
> (a) the total cash fund applied to the current annuity rate
>
> (b) the guaranteed benefits in annuity form, which are equivalent to the cash fund excluding final bonus applied to the guaranteed annuity rate.
>
> Since policies containing a guaranteed annuity rate are necessarily at least 10 years old, the guaranteed annuity will produce a higher level of income in only

a small minority of cases. Even in that minority the difference between (a) and (b) above is likely to be quite small."

14. Headdon's approach, the differential terminal bonus policy, was predicated on the assertion of the Society's right to treat all of its pensions business as providing primarily a cash fund for conversion at retirement into an annuity.

15. The Society had written business in precisely that form prior to 1988. In particular that was the form of certain pre-July 1988 additional voluntary contribution (AVC) contracts[1]. It had been the form of many Federated Superannuation Scheme for Universities (FSSU) contracts written prior to 1970[2]. Fundamentally, the statement asserted the right of the Society to approach all pension business in that way irrespective of the terms of the contracts. Also implicit in the statement was the assumption of a wide discretion to alter final bonus according to the benefits taken.

16. On 1 September, Headdon sent a confidential memo to the non-executive directors. He referred to press publicity of the previous weekend, enclosed a copy of the memorandum to staff, and set out the arithmetical consequences of the policy:

"Assume a policyholder has a cash fund at retirement of £100,000 made up as follows:

Guaranteed cash fund and declared bonus	£80,000
Final bonus	£20,000
	£100,000

If the policy contains a guaranteed annuity rate of 10% then the minimum income guaranteed by the policy is 10% of £80,000 i.e. £8,000 p.a.

If the current annuity rate is 10% or more then it is clearly in the policyholder's interests simply to use the cash fund on current annuity rates. If the current annuity rate is, say, 7.5% then the cash fund of £100,000 will only buy an income of £7,500 p.a. on current annuity rates, so the policyholder is better off taking the annuity guaranteed by the policy.

At intermediate positions, such as a current annuity rate of 9%, the cash fund will still secure a higher income on current annuity rates (i.e. £9,000 p.a.) than the guaranteed income. If, however, the policyholder realised that the guaranteed annuity rate of 10% was higher than the current annuity rate and insisted on making use of the guaranteed annuity rate, then the final bonus would be adjusted to £10,000 so that the benefits would be calculated as follows:

Guaranteed cash fund and declared bonus	£80,000
Adjusted final bonus	£10,000
	£90,000

Income produced on guaranteed annuity rate = £90,000 x 10% = £9,000 p.a."

17. The 'guaranteed annuity rate' referred to in the calculation was a rate reflecting both the mortality factor at retirement and the interest rate which, on the Society's approach to all of its pre 1 July 1988 annuity guarantee business, were implicit in the contract as applicable on conversion of the accumulated cash fund. The implicit interest rate was never higher than 7%. The Society's current annuity rates reflected current mortality assumptions and the current interest rates making up the conversion factor for immediate purchased annuity contracts.

18. The Society's practice, as reflected in this memorandum, involved substitution of rates reflecting current mortality and current interest assumptions for the contractual terms. It therefore compensated for any inadequacy in the contractual mortality assumptions in addition to the differences in the interest assumptions

[1] See Appendix B for glossary.
[2] See Appendix C for background notes on the FSSU.

driven by external market conditions. Headdon observed that the position he described had applied for a few years. He commented that the formal statement of bonus determined by the Board each year had allowed for final bonus to be adjusted as described, and that annual statements issued to policyholders had also mentioned the point.

19. The memorandum stated that it was important for directors to remember that the cash fund available under these policies represented the full value of accumulated contributions. Where the guaranteed level of income was higher than could be achieved on current annuity rates, policyholders were claiming an additional benefit, which would be unfair to the rest of the Society's with-profits policyholders on whom the cost would fall. One had in this statement to the non-executive directors a clear indication of the policy stance adopted by management as the issue became more controversial.

20. Media pressure on the Society at this time was becoming more intense. On 7 September executives of the Society met to discuss the situation. Headdon summarised the options and risks:

> "At one end there is the option of changing the approach to that which Bayliss is arguing for. The implications and risks associated with that may be summarised as
>
> > (i) A 'worst case' cost based upon current annuity rates and policy fund values of £1.5bn (ii) The reserving/solvency implications associated with meeting the cost
> >
> > (iii) The adverse affect on future bonus policy for either the whole of the with profit business or a sub-set of meeting the cost
> >
> > (iv) The PR implications of (ii) and (iii) which would be damaging and lasting.
>
> At the other end there is the option of continuing with the current approach. The implications and risks associated with that may be summarised as
>
> > (i) Loss of reputation for 'fairness' with as a consequence an adverse effect on our dealings with clients, new and existing
> >
> > (ii) An ongoing opportunity for IFAs etc. to attack us
> >
> > (iii) Open to comment that the approach is forced upon us because we are in a weak position (at the extreme we cannot afford to meet our guarantees).
>
> The possibility of positions between the extremes was discussed. Whilst it was felt that there may be merit in relaxing in some areas where a strict interpretation was available to us, and a virtue could possibly be made of that, a more general compromise position, if indeed one could be found, would not remove the implications and risks of the extremes."

21. Headdon emphasised that the current policy of the Society reflected the internal view held consistently over the previous fifteen years. The conclusions of the executives' meeting were:

> "It was agreed that even if at the end of the day we might not rely on the strict legal position it was imperative that immediate action was taken to confirm that our interpretation of the legal position was correct and also to get opinion on a small number of areas of uncertainty.
>
> Overall the view of the meeting after a wide ranging discussion was that we should
>
> > (a) continue with the current approach

> (b) continue with the current line of argument in support of that approach with the press and policyholders. This should be in a low key way
>
> (c) seek urgent confirmation of the legal position
>
> (d) take suitable urgent action to ringfence the problem, subject to confirmation of the legal position."

The practical implications, taking legal advice, setting out the arguments for internal use, and further briefing of directors were put in hand. It was made plain by Headdon that actuarial staff were expected to subscribe to the policy thereafter without question.

22. On 9 September there was an informal briefing meeting for directors. A note of the meeting was circulated on 11 September 1998. Headdon summarised the background. He told directors that there were approximately 100,000 retirement annuity policies and 20,000 individual pension plans containing annuity guarantees still in existence. In addition, there was an unknown but substantial number of group pension scheme members entitled to annuity guarantees. He made these comments:

> "Current annuity rates first fell below GARs in late 1993 and a special calculation of final bonus for cases where a GAR is exercised was introduced in the declaration at the end of 1993 (and was included in the formal Statement of Bonuses resulting from the Valuation and approved by the Board). This special calculation provides that where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus is reduced such that the annuity secured by applying the cash fund (so reduced) to the guaranteed annuity rate would be the same as applying the cash fund otherwise available to current annuity rates.
>
> CPH emphasised that the manner in which the Society is operating in respect of GARs is that which it always intended and that a change of approach would give rise to inequity between classes of policyholder.
>
> Our current approach can be summarised as follows:
>
> The income available to the policyholders is the higher of:
>
> (i) Fund (including final bonus) x current annuity rates
>
> (ii) Fund (excluding final bonus) x GAR."

23. Headdon reported that the guaranteed annuity rates included in policies issued from 1956 to 1975 were very close to the Society's then current annuity rates. Those contained in policies issued from 1975 to 1988 were approximately 25% higher than current annuity rates. That was where the main current problem lay. To apply the full fund (including full final bonus) to guaranteed annuity rates contained in policies would represent a potential cost of up to approximately £1 billion in respect of retirement annuity policies, subject to the inherent uncertainties arising from the long-term nature of the business, rising to approximately £1.5 billion with the inclusion of individual pension plans and group pension schemes. He said that the Society's current approach would also have some cost, if interest rates remained at current levels or became lower. He stated that he would make a reserve in respect of this liability at the end of year valuation, but it was not likely to be significant, and was likely to be in the order of £100m. Headdon also commented that a factor contributing to the cost to the Society was the flexibility of the Society's contract in providing annuity guarantees for retirement from ages 60 to 75.

24. Headdon informed the directors that executive management had concluded that meeting the annuity guarantees on full fund value was not tenable because of the very adverse effect such a change of approach would have on the Society's solvency position, the resulting restrictions on investment freedom and the effects

on bonuses which the Society could declare together with the major inequity which would inevitably be introduced between different groups of policyholder.

25. Headdon then went on to describe the calculation of policy benefits as they had been set out in the relevant policy documents. The approach adopted came to characterise the Society's approach to contractual interpretation throughout. The latest form of retirement annuity contract was selected as the basis for generalisations, ignoring the historical development of the policy forms. The interpretation most favourable to the Society's position was selected. And warnings by Dentons[3], the Society's solicitors, albeit tentative, were simply recorded. The calculation was described as follows:

> "Each premium secures an "Accumulation Value" which receives a 3½% per annum guaranteed roll up to the date the benefits are taken.
>
> The "Annuity" guaranteed by the policy = Accumulation Value x GAR
>
> The "Policy Annuity Value" = $\frac{\text{(Annuity - 'Related Bonuses')}}{\text{GAR}}$
>
> The policy provides that:
>
> "Related Bonuses" means ... such amounts (if any) as shall under the rules and regulations of the Society have been allotted by way of addition to or bonus thereon"

26. The Society's solicitor[4] confirmed that the directors had discretion regarding bonuses allotted to policies and referred to the wide powers given to the directors by regulation 65 of the Society's articles. He confirmed that, in his opinion, this enabled directors to take a differential approach between classes of policies and between benefits within a policy. He referred to the requirement that the directors must do justice between different classes of policyholder and expressed the view that this was what had been done by the Society. He added a caveat, however, that there was nothing in the policy conditions that would lead a policyholder to believe that a differential approach would be applied. The policy did not distinguish between 'related bonuses' applied to guaranteed rates and those applied to current rates. He thought that this could be the basis of an argument by a policyholder that he was led to believe that the same 'related bonuses' would apply both to guaranteed and current annuity rates. There is no record of the directors' response to the warning.

27. Headdon then rehearsed some of the material distributed to policyholders over time, and commented on the representations it contained. He commented that it was a potential weakness in the Society's position that until 1988 illustrations showed the fund including terminal bonus being applied to both the current annuity rate and the GAR. He thought that this position could be defended on the basis that that was what would have happened at the time. However, a policyholder could argue that this had led to an expectation that this approach would continue to apply. Also, it was likely that the existence of the guarantee had been drawn to clients' attention as part of the sales process at the time. There were detailed discussions of the form of annuity benefit available, the impact on transfers, and the enforcement of policy conditions. Directors were given a wide briefing on the issues. Among other decisions recorded, it was agreed that the solicitors should seek counsel's opinion on the strength of the Society's legal position.

28. The Society's management put in hand a range of practical exercises over the following period, providing information to staff, checking the Society's procedures on maturities, examining other policy types to identify guarantees, standardising letters of reply to enquiries, amending illustrations, and dealing with media. Vulnerability to a hostile take-over became an issue.

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[3] The law firm, Denton Hall, later Denton Wilde Sapte, later simply Dentons, which is referred to in the report generally as Dentons.

[4] Brian McGeough of Dentons.

29. There was a regular board meeting on 23 September 1998. The minutes set out a lengthy discussion of the guaranteed annuity rates issue. The chief executive, Alan Nash, had submitted a written report. The minutes set out his brief oral comments and Headdon's extended discussion. There was considerable repetition of earlier material. But the minutes can be taken to record the directors' understanding of the situation at a crucial stage, shortly before publication of the Society's position.

30. Headdon referred to ring-fencing of the annuity guarantee liabilities as an alternative to treating policyholders claiming the contractual benefits individually, and commented on the unfairness that would imply in the case of those within the annuity guarantee classes who elected to take benefits on current annuity terms. He repeated the description of the approach adopted, and the cost of implementing the guarantees. By now the Society had obtained counsel's opinion supporting the management's approach. The Board was advised of current steps to deal with the public relations issues that were emerging.

31. On 9 October 1998, Nash wrote to all non-executive directors. A further opinion from counsel had confirmed the regularity of the Society's actions, and was said to have given helpful advice on the amendment of the annual statements to reinforce the Society's position. He reported on a meeting with regulators which had taken place on 2 October:

> "A meeting has been held with the Treasury and Government Actuary's Department at their request, as I indicated at last month's Board. The Treasury/GAD are gathering information on how offices are dealing with the guarantee. I ran through our approach and responded to questions from those present. I, plus Chris Headdon and David Thomas who attended with me, gained the impression that the Treasury/GAD were reasonably comfortable with our approach and they expressed no real concern that we were failing to meet policyholders' reasonable expectations. That was on the basis of the consistent messages we have given to clients over the years about the aims of our bonus system in seeking equity between clients and on the basis of some warning notes regarding guarantees which we have included on annual statements over the last few years. In addition they recognised that the guarantee (of guaranteed annuity rate times guaranteed cash fund) was actually being operated by us.
>
> There was also some discussion on the most appropriate form of reserving for contracts with guaranteed annuity rates and on the possible impact on the statutory solvency position. Since the discussion involved detailed technical issues, Chris Headdon agreed to pursue that separately with the GAD and to produce some data on the Society's position as a basis for that further discussion."

The regulators' view of the meeting is recorded in a later chapter[5]. So far as those receiving the note were concerned, the import was that management had the support of counsel, and following discussions, reasonable comfort from regulators. Nash reported that a leaflet had been drafted, had been circulated to staff and was being used as the basis of responses to clients. A copy of the current text was attached to his letter. The draft leaflet was a bold and assertive expression of the Society's position along the lines discussed with the Society's lawyers.

32. On 14 October 1998 there was a meeting between management and some non-executive directors. Additional information was provided about the contacts with regulators:

> "Alan Nash, David Thomas and Chris Headdon had attended a meeting with the Treasury and the Government Actuary's Department. A detailed letter had been sent before that meeting, setting out the Society's approach. Alan Nash

[5] See chapter 17, paragraphs 25 to 27.

reported that the Treasury/Government Actuary's Department appeared to be reasonably comfortable with the Society's approach and that there was no indication that they would require a change in approach. The matter of reserving for the guarantees and the effect on solvency had been discussed and Chris Headdon was doing some further work on the reserving basis prior to discussing the matter further with the Government Actuary's Department. There were indications at the meeting that the Government Actuary's Department considered the current market volatility sufficiently unusual to be able to consider relaxing the normal resilience testing requirements. Alan Nash confirmed that the tone of the meeting was that the Treasury and Government Actuary's Department were reasonably supportive and appeared to be prepared to exercise some flexibility.

The point was made, however, that should policyholders complain to these or other Government departments they could take a different approach."

33. At the same meeting there was further discussion of steps taken to preserve mutuality. Salomon Schroder Smith Barney[6] had been consulted. Nash expressed the view that the current subjects of guaranteed annuity rates and solvency should not affect the position, and that the Society's strong stance in favour of mutuality should be maintained. The guaranteed annuity issue remained a major topic at board and committee level in October and November. A manuscript note from Julian Hirst, the Society's chief accountant, and apparently addressed to the risk management group, briefly recorded a meeting between Hirst, Nash, Roger Bowley, an executive director of the Society, and Alan Tritton, the chairman of the audit committee, on 28 October. The note records Tritton as pointing out that the guaranteed annuity issue had taken the Board and directors by surprise, and saying that he thought the Society needed a wider solvency margin and "perhaps need to reconsider our full distribution policy".

34. On 10 November 1998, there was a meeting with the Society's solicitors to discuss recent press articles. Media comment on the Society's position had been mixed. Those attending agreed that there should be a letter to all policyholders (c.650,000), which they should ideally receive on the same day, dealing with proceedings before the Ombudsman, inter alia. There was discussion of the Society's response should a writ be served.

35. At a further meeting on 11 November 1998 to review the guaranteed annuity position and associated public relations issues, involving some of the non-executive directors, there was discussion regarding the reasons for the Society first offering guaranteed annuity rates. There was also a question regarding when terminal bonuses were first introduced and whether the implications of these and guaranteed annuities were identified and consideration given to them at the time. Peter Martin, vice president and an experienced lawyer, advised that a confidentiality agreement be entered into when the Society paid out beyond the terms of the policy, and emphasised the need to pay 'without prejudice'. David Thomas, the investment director, noted that the unit-linked guarantees would have to be met by the "shareholders", "a point which had not yet been made in the press." The contributions suggested growing concern about the Society's public image.

36. At the Board meeting on 25 November, the requirement by regulators and GAD for full reserving for guarantee liabilities was discussed. Various options, including judicial review, were mentioned. It was reported that information had been sought by regulators on policyholders' reasonable expectations. The possibility of litigation on the annuity guarantee issue was raised, but deferred on Martin's advice until the reaction of policyholders and the press was clear.

37. On 9 December there was a further meeting between management and selected non-executive directors. The main issues were the outcome of the meeting

[6] For ease and consistency with the documents quoted, Salomon Schroder Smith Barney are referred to simply as 'Schroders' or by the acronym 'SSSB' throughout this report.

with HM Treasury and GAD and public relations. But the possibility of raising declaratory proceedings on the annuity guarantee issue was raised. It had been decided to prepare a writ, but not to serve it at that stage. Headdon reported that regulators had not dropped the question of policyholders' reasonable expectations and had asked for further information.

38. On reserving he reported that the official view was that it was necessary to have regard to the contract terms and to reserve for the whole of the primary benefit under each contract. The official view was that the primary benefit in individual pension and group pension contracts was a cash benefit, to which the guaranteed annuity was applied as a secondary benefit. In those cases the primary benefit had to be reserved in full, and a prudent provision made for the option, but not necessarily on the basis of full take-up. However, the retirement annuity contracts were, in GAD's view, written with the annuity as the primary benefit, and full reserving was required. The Society had argued strongly that the distinction was illogical. Counsel's opinion was being taken. Preparations for the declaratory proceedings were taken forward. The minutes make clear that the Society's actuaries had now had a firm statement of the official position on the application of the regulations to the Society's retirement annuity business. There was increasing pressure on the Society.

39. At a meeting on 16 December 1998, there was further discussion of the guaranteed annuity issue. Nash presented a wide-ranging report on the Society's financial position and options. The proposal to initiate declaratory litigation was discussed. Counsel were said to be firmly of the view that the directors did have the discretion on terminal bonus that they claimed. There was reference to further legal advice on the reserving issue in respect of which separate litigation was a possibility.

40. It appears to be clear that the Board were given substantial comfort by the opinions of Anthony Grabiner QC and Brian Green QC. Having been assured in firm terms that they were correct in the course adopted, there was no incentive for the directors and in particular the executives to revise their views. However, in order to meet some of the regulatory pressure on reserving, the possibility of financial reassurance was investigated, to take the liability off balance sheet if GAD did not change its mind. And the investment committee was considering means of easing the solvency position. There were also discussions with the Society's auditors on the presentation of figures.

41. The minute of the December meeting[7] indicated that the directors were informed in discussion that the actuaries' approach to the valuation of the annuity guarantees was dependent on the validity of the terminal bonus policy. The actuary again reported that the 'special calculation' for annuity guarantee cases had first been introduced at the 1993 declaration. The inquiry has not recovered anything in the nature of a detailed paper for the information and decision of the Board in December 1993.

42. In the actuary's report for the Board meeting of 27 January 1999 reserving was discussed in relation to particular factors rather than generally. The report dealt with reserving for annuity guarantees on three bases: (i) a 'best cautious estimate', appropriate for the statutory accounts; (ii) a prudent basis, appropriate for general regulatory requirements; and (iii) the basis for meeting the FSA and GAD guidance. At the meeting Nash reported on public relations matters relating to the guaranteed annuity issue. The declaratory proceedings had commenced. Nash told the Board that the declaratory action had been started earlier than expected to avoid solicitors acting for the action group from being able to issue a writ. Alan Hyman had been selected as representative defendant. Litigation was in hand. The narrative to this point reflects the position as presented to the Board. There had been contact with Hyman and others in the meantime.

[7] See also chapter 17, paragraphs 83 to 87.

Conduct of the *Hyman* Case

43. In September 1998 Hyman had requested a statement of the benefits currently payable under his policies. The information provided initially, dated 1 and 2 October 1998, illustrated a wide range of alternative benefits all computed by reference to the policy values of his contracts at current annuity rates. He requested an illustration of the benefits at the relevant guaranteed annuity rates in the hope that the outcome would be more favourable. An internal memorandum dated 5 October 1998 expressed the Society's view that taking benefits in guaranteed annuity form produced a lower annuity than that available from current annuity rates. It was stated that no special illustrations were required, in the view of the writer. The writer noted:

> "We compare guaranteed fund x guaranteed annuity rate with current fund x current rate and in each case the latter gives higher benefits."

The arithmetical exercise described by Headdon to executives and to the Board in September had been carried out.

44. Hyman persisted. On 9 October 1998 an illustration of the benefits payable should he require the implementation of the annuity guarantee demonstrated that on the Society's approach the outcome would be less favourable than on the application of current annuity rates. The Society's current annuity rates had been reduced in the interim, but Hyman was not informed of that change since he had not specifically asked for the information. Hyman had ready access to advice. He became aware of the approach adopted by the Society to calculating terminal bonus when the annuity guarantee was applied. He transferred his funds to Canada Life Assurance Company and intimated a complaint to the PIA Ombudsman. He had joined a growing band of disaffected policyholders and former policyholders of the Society.

45. After intimation of the first complaints by policyholders to the PIA Ombudsman in July 1998, the Society's executive management had in contemplation the alternative fora, in which challenge of the differential final bonus policy might be dealt with. Piecemeal disposal of individual complaints by the Ombudsman was possible, but not attractive. On 7 September 1998, the Society sought legal advice on a series of questions, as decided at the meeting of executives that day[8]. The solicitors responded on the following day, covering a range of questions, some of which were collateral to the central issues, but, in particular, they affirmed that the directors had discretion to reduce final bonus on the basis of the policy wording and the articles of association, but warned of the risk of contrary expectations generated by publications and communications with policyholders and possible exposure to claims on that basis.

46. The solicitors' letter, written at an early stage in the process that resulted in litigation, presented a reasonably balanced view of the issues that might confront the Society. Assessment of the collateral risks soon became subordinated to discussion of the strength of the Society's contractual position. Detailed instructions were prepared for counsel's advice on the most material questions. The instructions included the following statements and questions:

> "Overview
>
> Instructing Solicitors act for the Society. The Society is a mutual life assurance company whose members are its with-profits policyholders. Profits are allocated to members of the Society in the form of bonuses. Bonuses are of two types - "declared", i.e., bonuses which attach to policy benefits annually and thereafter become guaranteed policy benefits and "final" or "terminal" bonuses which are non-guaranteed and only finally determined when a policy claim becomes due for payment.

[8] See paragraph 21 above.

Between 1956 and 1 July 1988 the Society issued With-Profits retirement policies providing for benefits expressed in the form of an annuity at guaranteed rates depending on the age (between 60 and 75) at which the policyholder takes the annuity, and increased by "Related Bonuses" which provide the with-profits element of the benefit under the policy. No additional premium was charged in respect of the guarantee.

Policies other than the very earliest provide for a cash sum benefit corresponding to the annuity benefit to be calculated. When legislation was introduced in 1979 allowing the proceeds of a policy to be transferred to another provider at retirement as an "open market option", the Society allowed such transfers to be made without penalty. As a result of the availability of that option, communications with policyholders over the last decade have increasingly focused on the cash sum rather than annuity benefits.

In July 1988 the Society stopped writing retirement policies of this type and started writing personal pension plan policies which contain no annuity guarantee and which accumulate benefits solely in the form of a cash sum to be used to secure appropriate benefits at retirement. Those benefits include "Related Bonuses" which are defined in a similar manner to bonuses under the pre-July 1988 retirement annuity policies.

The pre-July 1988 retirement policies permitted policyholders to take the guaranteed annuity at the guaranteed rate or an annuity at the Society's current rate at the relevant time or an annuity with another company (the latter option being introduced by legislation in 1979).

Until 1993 the Society's current rates always produced a higher annuity than the guaranteed rates. The effect of recent interest rate reductions and longer life expectancies has meant that the guaranteed annuity rates are now usually above the corresponding current rates for the relevant age of policyholder.

As a mutual office the Society has sought to treat its members (i.e., its with-profits policyholders) equitably and in allocating bonuses the Directors try to ensure that justice is done between the various classes of with-profits policies and that the policyholders receive a fair return on their respective investments. The allocation of bonuses each year is and has been throughout the Society's history a carefully thought through decision based on actuarial advice and designed to promote fairness and equality between current policyholders and between different generations of policyholders.

In pursuit of this aim the approach followed by the Directors in recent years has been to treat retirement annuity policies in the same way as the corresponding post-June 1988 personal pension contracts, when the benefits are taken in the form of a cash sum to be applied on current annuity rates, but to reduce final bonus where the guaranteed annuity form of benefit is taken, in order to achieve benefits of the same actuarial value. This was judged to be a fairer treatment than the alternatives available, such as meeting the cost of the annuity guarantees by means of lower bonuses to the whole class which would have led to those policyholders who died or took the benefits in cash fund form receiving benefits of significantly lower value than those choosing the guaranteed annuity benefit.

The reduction in final bonuses has been expressed as the amount needed so that the resulting reduced fund applied to the guaranteed annuity rate will produce the same income as that which could have been achieved by applying the Society's current annuity rates to the total (unreduced) fund. The Society recognises that if annuity rates were to fall to such an extent that even a complete removal of the final bonus would not equalise guaranteed policy benefits with those under non-guaranteed Policies, the Society will be obliged to pay the guaranteed rates on the accumulated premiums and guaranteed (i.e., declared) bonuses. Policyholders taking benefits in guaranteed annuity

> form, therefore, never receive benefits of lower value than those taking cash sums and, in some cases, will receive more valuable benefits.
>
> To date, the cost of the additional benefits payable on those cases where the guaranteed annuity produced the higher level of income has been relatively modest and, except in extreme financial conditions, that situation is expected to continue. The effect on the general level of bonuses is, therefore, expected to be minimal. By comparison, the application of the guaranteed annuity rates to the full cash fund benefit including final bonus would lead to significantly higher benefits under policies where a guaranteed annuity is taken. The cost of that would need to be reflected in material reductions in bonus rates more generally with the consequence of significant inequity to other groups of with-profits policyholders.
>
> The above practice has applied since 1 January 1994 and retiring policyholders who have enquired as to the calculation of their benefits have been told that this treatment has been applied. The approach was explained more generally by means of a note on annual statements introduced in 1995....
>
> More recently, the matter of guaranteed annuity rates generally, and the Society's approach in particular, have been reported in the Press .... Adverse press comment has caused the Society to seek to confirm the legality (and conformity to its policy and other published documentation) of its treatment of retirement policies with a guaranteed annuity element."

The instructions then rehearsed various provisions of the policy forms, and set questions for counsel[9] in the following terms:

> "Counsel is now asked to advise in consultation and thereafter, if required by the Society, by written opinion on the following matters:
>
> 1. Does Counsel agree with Instructing Solicitors that under Article 65 of the Society's Articles of Association the Board of the Society has a complete discretion as to the allocation of bonuses among policyholders? Specifically,
>
> > (a) does their discretion permit them to award different bonuses to different classes of policyholder and, within any class, to different policyholders depending on those policyholder's choice of benefits?
> >
> > (b) the Board has always taken the view that, in exercising its discretion, it must act reasonably and fairly in the interests of the members of the Society (i.e. as a mutual, its with-profits policyholders) and of the various generations of members as described on page 4 of these Instructions. Does Counsel agree with this? If so, does this put any constraints on the exercise of the discretion in this case?
> >
> > (c) is the Board's power constrained by any statements made in the illustrations and communications to the policyholders sent herewith as documents 5 and 6 or the Society's leaflets sent herewith?
> >
> > (d) generally, is the method of dealing with the issue of guaranteed annuity policies set out in the note sent herewith as document 9 legally correct and in accordance with policy terms?
>
> (2) As mentioned above, the Society has dealt with the issue of paying for the guaranteed annuity rates by "charging" the holders of guaranteed annuity policies by means of a reduction in their final bonuses. Effectively, therefore, the expression "Related bonuses" has a different meaning in the expression "Annuity increased by Related Bonuses", where it is a lower amount, from that in the expression "Policy Annuity Value", where it is a higher amount. It is thought that the definition of "Related Bonuses" is

[9] Brian Green QC.

sufficiently flexible to produce these meanings. Does Counsel agree that this is the case or is the freedom of the Board to allot bonuses in its discretion in any way limited by the wording of the Policy?

(3) If a policyholder were to challenge the differential treatment of "Related Bonuses" under his policy, is he likely to succeed? If so, what would be the remedy afforded by the Court? Would it be feasible or desirable in Counsel's view to obtain a test case ruling on the matter. If so, what would be the procedure to achieve this?

(4) Given the statements already made in illustrations, literature and statements sent to policyholders over the years, are there any steps which the Society could take to improve its chances of succeeding in any argument with policyholders as mentioned at 3 above. One method which has occurred to Instructing Solicitors is to restate the bonus entitlements of all policyholders of this type (whether they wish to take the guaranteed annuity or not) by reducing the final bonuses but at the same time make a statement that, on an ex gratia basis, the Society would be prepared to make a larger amount of final bonus available to policyholders taking benefits other than the guaranteed annuity. Could this be done without the "Ex gratia" route coming within the options already granted to policyholders under the Fourth Schedule of the policy.

(5) Do the statements made in the leaflets and other documents enclosed as documents ... with these instructions given policyholders additional rights which are being contravened by the Society's present course of action in relation to guaranteed annuities. ..."

47. Instructions may, without any positive intent to influence counsel, so present issues for advice that the strengths in the client's position are exaggerated and possible weaknesses understated. The narrative excluded a number of the solicitors' own earlier reservations about the Society's position. A consultation was held on 17 September 1998. Counsel's answers to the relevant questions were:

"1. Counsel agreed with Instructing Solicitors. In this respect the Board of Directors could be regarded as trustees. The Courts will not interfere with the exercise of discretion by trustees unless there is mala fides. Even if the decision of the Board was irrational or based on irrelevant data but the Board would have reached the same conclusion if rational criteria had been used, the Court will not interfere .... If a different result would have been reached applying rational criteria, the Court would order the Board to reconsider its decision ... Applying this to the specific circumstances, Counsel said that if the Board had used its power to apply larger bonuses to policies with less advantageous terms than to those with the guaranteed terms, that would be defensible. If, however, the rationale for the use of the discretion was to reduce bonuses on the more expensive policies as they were too costly, this would be difficult to defend. The representatives of the Society present stated firmly that this was not how the discretion had been exercised: bonuses had been devised to give a fair return on all policies of the same business class, eg. life, pensions, etc.

2. [Specific issues]:

(a) Yes, subject to the general points mentioned at 1 above. The Society cited at the consultation the example of one of their Personal Pension Policies which had a guaranteed premium roll up of x per cent per annum. Bonuses declared on these policies were also declared at a lower rate than other policies of the same class without this guarantee.

(b) Counsel agreed.

(c) In Counsel's view, the only problematical document was document 4 which states on page 3 (first paragraph in column 2) that "a final share of

profits is also allotted at the point the policy benefits become contractually payable". This seemed to indicate that some form, however small, of final bonus would be payable in all cases. However, against this was the fact that no guarantee of the amount of final bonuses had ever been given. Chris Matthews of the Society noted that, in the more modern form of this leaflet, the word "may" is used instead of "is". Counsel also noted the need to redraft the annual statements assuming that the course suggested at Question 3 below is adopted.

(d) Counsel was unhappy with the opening sentence of the fifth paragraph of this note and with one of the comments in the press clipping which appeared to be derived from it. Mr Matthews of the Society noted that this Memorandum was being redrafted in fuller form.

3. Counsel stated that, in his view, the difficulty was that under the policy wording there was a requirement to establish the Policy Annuity Value first before the policyholder decided which benefit to take. Counsel considered that in effect the Society had allocated a rate of final bonus for guaranteed annuity policies which was a bonus at the lower rate but had provided for an additional final bonus if alternative non-guaranteed annuity benefits were chosen. In future, this should be made clear in bonus statements.

4. As a matter of law, in Counsel's view, such a policyholder would not succeed but defence of the action would, because of the presentation of bonuses to policyholders at the outset and subsequently during the life of the policies, be tougher than it might have been had the presentation been different. On the basis of the Hastings-Bass case, if the action was successful, the last four years' bonus allocations by the Society would be void and the Society would have to recalculate bonuses for that period.

5. [Continuing question 4] It would be feasible but not desirable in Counsel's view to obtain a test case ruling on the matter.

6. [Question 5] It was noted at the Conference that the annual statements would have to be re-cast if lower final bonus rates were to apply. This would give rise at the least to cosmetic difficulties where policyholders compare their previous annual statements with their new current statement.

7. [Question 5] In general, Counsel stated that these documents did not give rise to additional rights (save as mentioned at paragraph 2(c) above in relation to document 4). However, they gave rise to difficulties in explaining what is now being done.

Specifically - in relation to the annuity illustrations, the reference to "corresponding fund value" was not ideal wording since it did not sufficiently alert policyholders to the lower fund value which would apply if guaranteed rates applied. If the method of dealing with the issue referred to at Question 3 above is used then, again, these illustrations will need to be redrafted. There is also the issue of whether the guaranteed annuity illustration should be given to all policyholders enquiring about retirement benefits where any reduction in final bonus applied because of guaranteed rates. It is understood that the Society's current policy on this issue is to give two illustrations only where guaranteed rates give rise to a higher annuity amount after total exhaustion of the final bonus.

[Another issue for the Society is how the cash fund value is calculated based on the method of declaring bonuses which refer to an annuity amount rather than a cash fund value amount. Is the cash fund based on guaranteed rates or current rates?] ..."

48. Further instructions and advice followed on particular issues, but these initial exchanges set the tone of the legal advice tendered over the following days. The re-interpretation in answer 3 of the actual practice of the Society was ingenious, but

difficult to reconcile with Matthews' statement to the PIT on 2 April 1998 or Headdon's analysis of the position on 28 August.

49. Counsel provided a written opinion on 11 October, confirming earlier advice, and expanding on his proposals for revising the annual statements of benefits:

> "This opinion is supplemental to the settled note of consultation held on 17 September 1998, and is written in response to my further instructions dated 2 October 1998.
>
> 1. At a further consultation on 25 September 1998, the Society further explained its practices in relation to the allocation of bonuses, and the representation of the ongoing value of with-profits policies to individual policyholders in the various generations of annual statement which have been issued. Having had the benefit of the Society's further explanation, I confirmed the advice given on 17 September 1998 and set out in the settled note of that consultation.
>
> 2. In particular, I confirmed that the Society was justified in law in adopting the approach of declaring different final bonuses in order to ensure (so far as was possible having regard to the operation of guaranteed annuities on previously guaranteed values) that the ultimate "cash value" of any given policy would be a single sum, irrespective of whether the policyholder took the guaranteed benefits under his policy, or elected to take an alternative annuity based on an application of current annuity rates.
>
> 3. Having regard to the wording of the policy documentation, in current economic conditions, this approach required a two-stage process of bonus allocation to any particular member of the Society who had a guaranteed annuity policy. First, the allocation of a lower final bonus to guaranteed annuity policies (FBG) than that which would be declared in the case of a policy which did not contain guarantees (FBNG). Second, in the case of any guaranteed annuity policyholder who wished to take an alternative annuity based on current annuity rates, the allocation of a top-up element of bonus representing the difference between FBNG and FBG.
>
> 4. In the language of the relevant retirement annuity policy documentation, only FBG would constitute "Related Bonuses" in the strict sense. The top-up element would be allocated by the Board of the Society as a separate exercise of its discretion under Article 65, which is a wide enough discretion to enable bonuses to be allocated amongst members in 'top-up' form, as well as in annual and final (or 'terminal') form as conventionally understood.
>
> 5. The Board's decision to seek to achieve a result under which all persons holding similar policies achieve the same investment return, irrespective of whether some policyholders had the benefit of guaranteed annuity rates applicable to guaranteed benefits, is perfectly legitimate. Guaranteed annuity rates, just like guaranteed values, confer valuable rights nevertheless; as is clear whenever a case arises where the cash value (that is the present value) of an application of such guaranteed rates to guaranteed values is greater than that which would be available if current annuity rates were applied to such guaranteed values plus FBNG.
>
> 6. The statement of "cash values" in the annual statements is the most useful manner of presenting the 'value' of a member's policy benefits. However, the abbreviated manner in which such cash values have been presented in the past has not served the Society well in now attempting an explanation of the above practices.
>
> 7. Statement of guaranteed values is clearly necessary, for it is to these values that any applicable annuity rates will be applied as of right. Further, it

is clearly desirable that a policyholder should have some sense of the final value of his policy.

8. What is not made sufficiently clear in the annual statements is that, in the economic conditions prevailing at the date of the annual statements in question, the total value will depend on two factors. First, whether guaranteed annuity rates apply to the policy. Second, on the level of non-guaranteed final bonus added to the policy by the Society in exercise of its discretion reserved under the policy. In the economic conditions prevailing at the date of any given annual statement the total value of the benefits provided under the policy will be the stated figure. But the amount of non-guaranteed final bonus which will need to be added to the policy in order to reach that total value will vary according to whether the annuity rates under the policy are guaranteed or not.

9. The non-guaranteed final bonus figures quoted in the annual statement represent FBNG. What needs to be got across to policyholders is that the actual final bonus paid in relation to them may be a lesser sum if they have the benefit of guaranteed annuity rates applicable to guaranteed values, but that - since if they take a guaranteed annuity the Society will be applying the guaranteed annuity rates to any final bonus allocated - the total value of policy will not be reduced by one penny as a result.

10. It follows that in the case of a guaranteed annuity policy, the guaranteed value stated may in current economic conditions - actually purchase a larger annuity than were current annuity rates to be applied. In other words, whereas the total value figure attempts to state an aggregate cash equivalent value for benefits payable under the policy irrespective of the annuity rates to be applied, the guaranteed value figure is not a cash equivalent of the benefits which would be available irrespective of the annuity rates to be applied. This follows from the past practice of the Society in adding the same annual bonuses to all retirement annuity policies irrespective of whether or not annuity rates were guaranteed under such policies.

11. The abbreviated nature of the annual statement tends to obscure the fact that a number of different things are being stated in a single table which tends to create an impression that one is comparing like with like at all stages, when one is not (or may not be) doing so.

12. The guaranteed value is the guaranteed cash sum which will be made available by the Society for the purpose of securing the benefits to which the member is entitled under the terms of his policy, irrespective of the level of annuity rates applicable thereto at the date that the policy benefits are taken.

13. The total value is the cash equivalent value of the aggregate benefits which the member could expect under his policy on an application of whichever annuity rates are applicable to the benefit taken by him. What is being stated is that, taking due account of such presently non-guaranteed final bonuses as could be expected to be added to the member's policy were he to take his benefits as of 1 April following the date of the annual statement the cash equivalent value of his policy will be its total value; and this will be so irrespective of whether he takes his annuity in a form which attracts more generous guaranteed annuity rates or current annuity rates.

14. The non-guaranteed final bonus as stated is such sum as the Society would be adding to the guaranteed value in current economic conditions in order to produce the total value, on the assumption that more generous guaranteed annuity rates do not apply. It is the sum which the Society will need to allocate to the policy by way of addition to the guaranteed value in order to produce the stated total value, if current annuity rates apply to the benefits actually taken.

15. What is missing is an explanation that, where guaranteed annuity rates exceed current annuity rates, the sum which the Society will need to add by

way of non-guaranteed final bonus will be less in order to produce the stated total value. In other words, that the non-guaranteed final bonus figure is a maximum figure stated in current economic conditions.

16. For my own part, I would prefer to see the annual statements recast so as to make the foregoing absolutely clear. That is, so as to explain clearly that guaranteed value is a sum which will - in the economic conditions prevailing at the date of the annual statement - buy greater benefits for a person enjoying the benefit of guaranteed annuity rates. And so as to explain clearly that the total value of the policy is the greater non-guaranteed cash equivalent value of the policy benefits (inclusive of guaranteed annuity rates where applicable). The annual statement would then state that the Society would be securing the difference between the guaranteed value and the greater non-guaranteed cash equivalent value by the allocation of discretionary final bonuses when the benefits are taken under the policy. The non-guaranteed final bonus figure - if it has to be included - would then be stated as an indicator of the sum which the Society would need to add by way of final bonus were current annuity rates to be applied to the guaranteed value, in order to produce the total value.

17. Any explanatory leaflet could then explain that for many years current annuity rates had exceeded guaranteed annuity rates, and the Society had in practice stated non-guaranteed final bonuses on that basis accordingly. In recent times guaranteed annuity rates had exceeded current annuity rates, but the Society had continued with the previous practice in the interests of consistency. The cash equivalent value of the annuity which the guaranteed value of the policy could secure if the benefits were taken in the current environment was presently greater than the value of the benefits available to those without the benefit of guaranteed rates (although economic conditions could always change), and the dependence of such policyholders on an additional non-guaranteed final bonus which would be necessary in order to bring the total value of the benefits up to the stated total value would therefore be smaller so long as (and to the extent that) the differential in favour of guaranteed annuity rates continued to exist.

18. I believe that a presentation and explanation along the above lines would best serve the Society's interests in the present circumstances.

19. I have settled the notes and insert to the annual statement sent to me under cover of my instructing solicitors' letter of 7 October 1998 in accordance with the above advice. In the interests of further clarity, I would prefer to see the expression guaranteed sum substituted for the expression guaranteed value (since the value of the benefits secured by the so-called 'guaranteed value', will depend in fact on applicable annuity rates); but if continuity or other commercial considerations dictate otherwise, so be it. I assume that the Society will have its own comments on the enclosed.

20. I understand that the Society is working on a re-draft of a proposed explanatory leaflet intended to provide a definitive explanation of past and present practice, which I will be glad to look over in due course. I will then give consideration to the possibility and/or desirability of including further material along the lines suggested at points 3(b)(i)-(v) of my instructions in that leaflet. I do not believe that it is necessary to canvas such matters further in relation to the proposed revised annual statement."

50. Counsel had provided strong support to the Society. His interpretation of the Society's past practice was encouraging and imaginative . The steps suggested to strengthen the Society's position appear to have reflected his view of what had happened in fact, though I have not found any evidence that matters had been so presented by the Society itself in literature or correspondence with third parties, or in internal communications. The advice was taken up in the statements of benefits issued for 1998.

51. The Society and its legal advisers continued discussions. On 21 October the risks associated with the Society's discovery obligations if there should be litigation were discussed. Solicitors advised on the scope of documentary material likely to be discoverable. As the autumn proceeded, the directors began planning for the possibility that a writ would be served on the Society. In those circumstances it was agreed that the Society would wish to take the initiative by raising declaratory proceedings, initially with two 'tame' defendants, one policyholder with a guaranteed annuity and one with a non-guaranteed annuity. Counsel remained of the view that court action was not indicated. The possibility of policyholders obtaining by discovery papers relating to a number of specific cases was considered again.

52. A meeting with counsel was held on 23 November 1998. Counsel's emphatic view then was that it was not in the Society's best interests to bring the matter into court. He advised that the question should be reviewed if proceedings became inevitable. However, if there were to be action, counsel advised that the Society should stay in the driving seat. At that stage the view was that the case was capable of being lost. The estimate of the potential liability was £1.5 billion and the Society's actuaries considered that that would raise solvency issues. Counsel suggested that the Society should consult its auditors. Although it was not spelled out, a material consideration must have been that , if the case came into court before counsel's proposals for amendment of the benefits statements matured, the potential benefits of the amendments might be lost.

53. On 25 November 1998 the Society's legal advisers returned to the issue of litigation and the advantages of taking the initiative. The two main advantages of raising declaratory proceedings were said to be:

> "(i) The Society could define the issues, at least initially. The Society's originating summons would be the first thing the Court read. The Society would have greater control over the conduct of the proceedings and might be able to limit discovery; and
>
> (ii) It would be a pre-emptive strike - the Society could choose its forum. The issue of proceedings would exclude jurisdiction of the PIA and Pensions Ombudsman in relation to future complaints. The solicitors said that the Society might get a better hearing if it went to Court first, rather than going to Court on appeal from an unfavourable Ombudsman's decision, a course which in any event would cause delay and significant public relations problems."

The solicitors advised that it would only be appropriate for the Society to consider taking the initiative if it did not succeed in taking the matter "off the agenda". The PR implications of litigation would have to be handled with great care. There was thought to be an advantage in the Society commencing proceedings rather than being named as defendant. The solicitors advised delay to see what happened in the press, then at the appropriate time issue proceedings but not serve them. They discussed the range of possible defendants. The advice remained that there should be two representing the classes already identified. It was agreed that the purpose of any litigation commenced by the Society would be to get a declaration from the Court on general principles. Questions were asked about the possible consequences for the Society, and about the Court's powers. The solicitors' advice was that the Society should not litigate unless it had strong reasons why it would be in its interest to do so, but should prepare the necessary papers to go ahead swiftly if need be.

54. Comprehensive preparations were discussed for the issue of proceedings with two defendants. By now discussions with the auditors were in hand. On 3 December Martin proposed that the Society should raise declaratory proceedings to ensure that the Society kept the initiative. Other directors remained undecided. They argued that the Society should not appear to be seen to be attacking the Ombudsman (e.g. by going to court), as he was viewed as the 'small man's friend'. Preparations proceeded nevertheless.

55. On 9 December 1998, it was decided that a final decision on proceedings would be taken on 14 December. Instructions sent by the Society's solicitors to counsel[10] on 9 December discussed the merits of initiating litigation and the options open to the Society for dealing with the PIA complaints. The Society had decided that work should proceed on the drafting of proceedings, subject to counsel's recommendations on strategy. The view expressed to counsel was largely repetitive of earlier comment. The Society would be able to define the issues it wanted to put before the court. It would be in a much stronger position to limit discovery. It would have much greater control of the process and of its timing. It would not have to face a multiplicity of complaints to the PIA Ombudsman. And the Society might derive a benefit in terms of public perception. On the other hand, the Society appreciated that it would precipitate a high profile case.

56. The instructions informed counsel that there were other types of guarantees than the guaranteed annuity rates in respect of which the amount of final bonus allotted was reduced by the amount of the increase obtained by virtue of the guarantee, thus opening up the possibility of a wider dispute. It was suggested that the Society had always declared differential bonuses for policies with a guaranteed investment return. Instructions to junior counsel to draft proceedings were issued on 10 December. The instructions were open in relation to the scope of the litigation. The solicitors were unclear whether all guarantees should be covered "insofar as the Society in effect differentiates between final bonuses depending upon whether the policyholder elects to take advantage of those guarantees".

57. On 14 December counsel advised that the Society's case was solid. The advice encouraged litigation at the instance of the Society. The note of conference reflected the tone as well as the content of the advice given:

> "1 Key issues
>
> Mr Grabiner said that overall the matter presented to him in his Instructions was not one related to policyholders' reasonable expectations but was a matter of construction of the contractual relationship between the Society and the relevant policyholders. Whilst one could not be sure that there were no policyholders who could successfully allege that they were promised full fund x guaranteed rate, one would have to work on the basis that all the promises were contained in the policy.
>
> On this basis the key issue was whether there was ever a promise to pay the full fund including final bonus and on this issue Mr Grabiner was clear that there was no such promise.
>
> Equally, he was clear that the Society had never promised that all policyholders would share equally in bonus entitlement.
>
> The contrary argument would be the "salesman's promise". However, any promise made would not normally be regarded by the court as an actionable representation as to the future conduct of the Society in relation to discretionary allocation of bonuses.
>
> Policyholders' reasonable expectations based on the way in which the directors had exercised their discretion in the allotment of final bonuses were irrelevant to the construction issue. He thought that the directors had exercised their discretion properly and that their legal case was "solid".
>
> The Society should, however, expect to be criticised about the way in which the Society had explained its approach in the past.
>
> 2. PIA Ombudsman
>
> Mr Grabiner was firmly of the view that none of the existing complaints should be dealt with substantively by the PIA Ombudsman. Mr Grabiner said that the

[10] Anthony Grabiner QC and Brian Green QC.

Ombudsman would not take account of the legal points to the extent that a court would, and was generally more favourable to the complainant than to the insurance company. In effect, it was a "merits tribunal".

Given this the options appeared to be:-

(a) go to court for directions i.e. ask the Court how the Society should exercise its discretion in relation to bonuses for the future, and/or

(b) go to court in relation to policies which had already matured (i.e. past issues as to what the Society had done).

Mr Grabiner recommended two test cases, one to deal with (a) and the other to deal with (b).

He was of the view that if the matter proceeded to court without delay there would be a decision from the High Court by the end of 1999 and, he hoped, earlier.

Mr Grabiner stressed that the Society must be full and very frank with the court in its explanations.

Leading Counsel said that they did not believe the PIA Ombudsman had jurisdiction in relation to the existing complaints because they related to bonus issues.

Denton Hall will draft a letter to the PIA Ombudsman giving a notice under clause 7 of the Terms of Reference and seeking the exercise of his discretion to cease to deal with the existing Complaints."

58. There followed a lengthy discussion of the classes of policyholder to be targeted in the litigation. Grabiner was keen to involve representatives of a wider range of classes. He thought that the Society would wish the court to approve:-

(1) the basis on which the directors were proposing to allot or make available final bonuses for 1999 and future years;

(2) the basis upon which the directors have exercised their discretion in the past.

Reserving

59. In addition to the dispute over the Society's terminal bonus policy, there was the issue between the Society and HM Treasury relating to the Society's practice in relation to reserving for annuity guarantees[11]. The two topics inter-mingled in discussion. Grabiner's initial view was that the Treasury approach was nonsensical as they were apparently saying that the Board was bound to give the same bonus to all policyholders, which was clearly not the case. Headdon explained his view of the official approach, and the Society's response, that took account of anticipated take-up rates. The representatives of the Society outlined the courses open to them if the Treasury's view was allowed to prevail namely: -

(a) to publish a barely solvent position as at 31st December 1998; or

(b) to change their investment strategy which although less of a PR disaster than option (a) would nonetheless be a PR problem; or

(c) not to declare a bonus as at 31.12.98 and only announce final (i.e. non-guaranteed) bonuses.

In practical financial terms, disclosure of the financial implications of the Treasury view would have further adverse public relations implications. If the Society reserved in full for the £1.5 billion involved, its free assets would be wiped out and there would be no funds from which bonuses could be paid.

[11] See paragraph 38 above.

60. Grabiner and Green commented that it was in any event nonsense for the Treasury to base its view on whether the policy promised an annuity with other options or promised some fund benefit with an option to take a guaranteed annuity. In the opinion of leading counsel there was no need to reserve for the entire risk since the regulations clearly allowed actuarial judgment to be taken into account. They could not comment on the actuarial judgment itself. Leading counsel advised that in view of the seriousness of this problem, an opinion should be drafted by them jointly which the Society should send to the Treasury in advance of a meeting to be arranged with the Treasury early the following week. Issues to be addressed in this opinion were then discussed. If the Treasury did not change their mind, the Society would have to consider judicial review.

61. Counsel indicated two possible bases for judicial review , first that the Treasury were misconstruing regulation 64 of the accounts regulations[12], second that the Society had a legitimate expectation that the Treasury would apply the regulations consistently and not change its stance given that the Society's returns from 1994 onwards had made it very clear that the Society had not reserved for guaranteed annuity rates on a 100% take-up basis. As to the misconstruction argument, the Treasury's argument that companies were supposed to work down regulation 64(3), starting with the "primary" benefit under the policy, was felt to have no justification. Headdon said that he had in mind an arrangement with two reinsurers in order to support the solvency position. If they came back with good rates, reflecting their assessment of the risk, it would support the Society's argument that there was no real risk. Counsel gave advice on specific questions supportive of the Society's position.

62. The advice received from counsel was uncompromisingly enthusiastic in its support of the Society's stance on each of the principal issues at the time. A formal decision to have the differential terminal bonus decided by the court was taken by the Board on 16 December. On the same day the Society's solicitors wrote to the PIA Ombudsman requesting that he cede jurisdiction. The joint opinion was issued on 18 December. It set out a comprehensive analysis of the facts as understood by counsel, analysed the arguments on reserving, and advised judicial review if the Treasury did not capitulate.

63. Preparations for the litigation at the end of 1998 and during the early part of 1999 explain the narrow basis on which the issue was put to the court in the first instance. The directors' decisions were based on strategic considerations discussed with counsel. Many of the potentially wider issues were excluded by the end of 1998, but re-visited. The draft originating summons settled on 18 December 1998 had six defendants. There were two with-GAR retirement annuity policyholders, one in pension and one prospective; two GAR individual pension plan policyholders, one in pension and one prospective; and two GAR group pension plan policyholders, one in pension and one prospective. There was no non-GAR representative. And the wider guarantees were not dealt with.

64. The representation of non-GAR policyholders was considered again on 4 January 1999. Counsel advised that it was not necessary to have a representative defendant for those whose policies did not include a GAR: it could lead to unnecessary complication and in any event the Society could put the points to be made in relation to such policyholders. Further, the Society had not made up its mind whether, should the decision go against it or should the Treasury decide on very onerous reserving requirements, the consequences should be borne simply by GAR policyholders or all with-profits policyholders. The Society wished to retain control of these issues: an independent view might not support its wishes.

65. Strategic decisions taken at this stage included:

(i) reservation of the Society's position on ring-fencing the annuity guarantee liabilities if the primary case failed;

[12] Insurance Companies regulations 1994, SI 1994/1516.

(ii) the progressive narrowing of the range of defendant interests to be represented; and

(iii) the restriction of the issues to those relating to guaranteed annuity rates, excluding other forms of guarantee.

66. On 5 January the Society's solicitors wrote to Hyman informing him that it was proposed he should be the first of two defendants in the proposed action. Similar letters were sent to other prospective defendants. On 6 January the solicitors reported that it was the intention to proceed with two representative defendants. The solicitors wrote to the Society on 7 January 1999 sending a copy of the draft summons and a copy of a letter to the PIA Ombudsman. Hyman was now the only defendant, following the view expressed by counsel that the summons should not refer to the future allocation of bonus. The letter to the Ombudsman, sent on 8 January, informed him of the intention to raise one test case on the view that that would be quicker, simpler and cheaper. The solicitors informed the directors of the up-to-date position of the draft summons on 11 January. Earlier strategic decisions were referred to. The selection of Hyman appears to have reflected a decision that:

> "... the representative defendant must be a PIA complainant, have taken his benefits and ideally have no other with-profits policies with the Society."

It was said that there might be PR disadvantages in selecting an old man, one only of 600,000 policyholders, and no longer a policyholder with the Society. The Society was advised that it was now committed to litigation.

67. In a note of consultation with counsel[13] dated 13 January 1999, the earlier suggestion that the Treasury approach to reserving for the annuity guarantees should be judicially reviewed was abandoned. Grabiner said that the logic behind the Treasury's argument that the Society should reserve in respect of guaranteed annuities was forceful. He advised that the Society should not go to court to challenge the Treasury's decision by way of judicial review. He confirmed that the usual tests for judicial review were not satisfied. This change of opinion did not undermine the general enthusiasm for declaratory litigation. Grabiner agreed with the solicitors that the Society should issue legal proceedings as soon as possible, even though the outcome of the application to the PIA Ombudsman to renounce jurisdiction was not known. He emphasised that if an action group issued proceedings first the Society would be defendants and lose control of the litigation.

68. On 13 January Hyman was put on notice that the Society intended to proceed, citing him as defendant. He responded by telephone on 14 January, initially leaving a message. Any apprehension that the Society had selected an 'old man' was quickly dispelled:

> "The message said that he had received an extraordinary letter from the firm in relation to the Equitable. He had tried to speak to Alan Nash but "as you know" Alan Nash never answers a telephone call. Those he had spoken to were 'paralytically incompetent and could not answer a single question'."

The Society had not selected a compliant defendant. The PIA Ombudsman wrote to complainants on 15 January explaining his decision that the test case should proceed. A copy of the originating summons was sent to Hyman the same day.

69. On 28 January 1999 Norton Rose informed the Society's solicitors that they had instructed Sumption QC for the defendant. Parties' legal advisers thereafter resolved a number of technical issues relating to the proceedings. They negotiated the terms of a draft notice of appointment to hear the Summons. It was agreed that the issue was one of construction of the Society's articles. There were discussions about the form of relief to be sought by the Society. Hyman's solicitors wrote to the Society's solicitors on 16 February intimating the view of counsel as to the issues

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[13] Anthony Grabiner QC and Brian Green QC again.

raised and making proposals as to the directions that might be sought. Amendments were required to the originating summons. The hearing took place on 23 February following final negotiations between counsel. The necessary orders were agreed and pronounced.

70. The Society informed policyholders of the decision to initiate proceedings by letter dated 19 January. On 4 February there was further extensive discussion in conference about the scope of the litigation. The extent to which Sumption might agree specification of the issues; the use of the Society's literature; the risk that the judge would order a trial; the scope of discovery; the approach to exhibits; the timetable for the proceedings; clients' instructions; and contacts with action group solicitors were discussed in detail. The draft affidavit for submission by Nash was discussed, as were the terms of counsels' instructions. On 16 February 1999, there were two conferences. In the first timetable objectives were discussed. Those present, the solicitors and counsel, then discussed the form of affidavit, and went on to other matters:

> "2. CIML [Cindy Leslie, solicitor for the Society] said that the Affidavit had been amended in order to make it punchier and to take some of the repetition out. As a result, our view was that the Affidavit was now in reasonable shape. AG [Grabiner] said that he had various comments on an earlier draft of the Affidavit and it was agreed that he and BG [Green] would now review the current version. ...
>
> Exhibits
>
> 4. It was explained that we had produced a core bundle of exhibits comprising of two lever arch files for the purposes of the Affidavit. This was made up of a fair selection of the key documents. There then followed a general discussion as to what documents should be put before the Court and what effect that would have on an Issue Estoppel[14] in the future. The concern was that by not placing a particular document before the Court but simply disclosing it to Norton Rose, that could result in an argument that strictly speaking that document was not subject to any Issue Estoppel. In that context, the documents in the main files were just as relevant as the documents in the core bundle which had been created. AG indicated that it was always a very difficult question as to whether a particular point had been in "issue". CIML and BG stated that our concern was to try to shut out as many future cases as possible. By including all the documents, that may assist in shutting out those cases on the basis that the documents had already been considered by the Court. ...
>
> 5. After a discussion, it was agreed that the best way of proceeding would be to exhibit the core bundle of documents to Alan Nash's Affidavit, and then to also exhibit all the policy and explanatory documents to an Affidavit to be sworn by CIML. The core bundle and main bundle would be paginated but then the core bundle documents would also include the document number used in the main bundle. CIML's Affidavit could contain words to the effect that the Society has given full disclosure of all documents in its custody, possession or power of which it is aware and that the vast majority of those documents were irrelevant.
>
> 6. In relation to the core bundle, AG said that it was important, as far as possible, to be able to read the documents in context so that it was not possible for the other side just to focus on wording on individual documents without seeing those in the overall context.
>
> 7. CIML explained that the main documents that the Society was concerned about were the Illustrations and some of the original marketing documents.

[14] Issue Estoppel: rule of evidence whereby failure to raise an issue at an appropriate juncture in proceedings may prevent it being raised later.

The Originating Summons

> 8. CIML and AG discussed the issue of whether we should refer to the leaflets in the declarations sought by the Originating Summons. AG said that our case was that the explanatory leaflets had no force and were simply pieces of paper which were irrelevant. Our case was that the bargain was a bargain. Therefore, we did not need to refer to the leaflets in the paragraph in the Originating Summons.
>
> 9. AG also considered the wording concerning an Issue Estoppel in the Originating Summons. AG said that this amounted to a declaration of the self-evident and AG had no problem with including it. Whether the wording was included would have no impact on somebody trying to base a case on facts not before the Court."

71. The tactical discussions at this stage extended beyond the declaratory issue. In particular, preparations to meet future challenge on the basis of issue estoppel had become a material factor in the Society's litigation tactics. In the light of later events, the most significant factor identified in the discussions related to ring-fencing of the annuity guarantee liabilities should the Society fail in its principal contentions. Ring-fencing of annuity guarantee liabilities was referred to in Nash's affidavit.

72. There was a second consultation on the same day with officers of the Society[15] present. There was discussion of policyholder expectations in the light of current queries. There was extensive reference to issues of current concern in correspondence with policyholders. Green drew attention to the possible answer to his contentions that GARs were, as a consequence of the primary argument, meaningless because what a policyholder got was entirely dependent on the size of the pot. There was extensive discussion of 'asset share'[16]. More directly related to the issue before the court, there was further discussion of Nash's affidavit. Green wanted to present the argument that this was a very simple case. It was purely a question of legal construction as to what the policies promised. He could then back that up with the concept of 'asset share'. That would then put the burden on the other side to make the argument either that the background material was relevant or alternatively for them to say that the construction argument went the other way. The temptation of the Judge would be to view the position in strict legal terms.

73. Procedural issues were discussed. On the merits, Green said that both the policies and article 65 were perfectly clear. He had seen quite a lot of the relevant papers and his opinion was that it was a very difficult argument, on the basis of those documents, that the terminal bonus was guaranteed. He said that as a result, he thought the other side would come up with some other type of argument. Matthews' concern was that policyholders could argue that they had an expectation that they would obtain the final bonus. Green thought that the expression 'reasonable expectations' was very vague. He considered that for a term to have legal effect, there needed to be a representation, contractual term or warranty as the basis for such an argument. Even if any such 'reasonable expectations' were implicit, they were not contractual. There was a huge difference between a contractual obligation and not coming up to policyholders' expectations. The Society needed a judge who would "adopt an intellectually vigorous (sic) approach". He repeated his view that, on what he had seen, there was no question of a legitimate expectation claim succeeding. The emphasis on strict contractual issues was now total, both generally and in relation to the scope for policyholders' reasonable expectations of benefit.

74. On the basis of these discussions it might be that the Society's officers were encouraged to entertain somewhat exaggerated expectations of success in the

[15] Chris Matthews & Peter Wilmot, the secretary to the Society

[16] See chapter 13 for further discussion of 'asset share' in the context of interpretation of policyholders' reasonable expectations.

litigation. The strategy under development concentrated on the analysis of the factors supporting the Society and, it appears, gave inadequate attention to the risks inherent in any litigation process. The substance of some of the arguments advanced, such as those relating to policyholders' reasonable expectations, is considered in Part V of the report. But it appears clear that the tenor of the advice offered depended to a considerable extent on the issue being disposed of by what counsel considered a judge with an intellectually 'vigorous' or rigorous approach to the terms of the contracts in question. Subject to that requirement, it appears that, by this stage, a certain euphoria had become established.

75. On 18 February the solicitors wrote to Matthews setting out the procedural steps then anticipated. The first procedural hearing was listed for 23 February. Directions would be sought on a number of issues, including a direction that there would be no cross-examination of witnesses who provided affidavits. To an observer from a different legal system, this appears to confer undue authority on documents prepared with considerable legal input. But at the end of the day nothing turned on the Society's affidavits. Detailed preparations continued and were reported in similar vein. On 24 June a fact sheet was published informing policyholders of the likely timetable for the hearing at first instance. The issue for trial was stated in these terms:

> "Since market annuity rates first fell below the guaranteed annuity rates in 1993, the Society has calculated different final bonuses where benefits are taken in guaranteed annuity form. The intention is to make the value of benefits so far as possible the same as if they had been taken in fund form to purchase an annuity in the market.
>
> The Society is seeking a declaration from the Court that
>
> - it has powers under its articles to allot different final bonuses in this way and;
> - it has exercised those powers validly."

The fact sheet was sent to policyholders under cover of a letter dated 29 June 1999.

76. The case proceeded to a hearing. The Society succeeded before the Vice-Chancellor. On 16 September 1999 the Society wrote to policyholders expressing pleasure that the Vice-Chancellor had decided the case totally in the Society's favour; and that the decision had cleared the approach to policies containing guaranteed annuity rates. The letter reiterated the claim that the Society had acted fairly. It summarised the result of the decision as follows:

> "The Vice-Chancellor's judgment is positive approval of our approach and confirms that:
>
> - our directors have discretion "well wide enough" to grant final bonus of an amount depending on how the benefits are taken by a policyholder;
> - there is no "policyholders' reasonable expectation" that the same rate of final bonus would be applied to all policyholders; and our approach does not involve "depriving policyholders of part of their asset share" as had been alleged.
>
> The Vice-Chancellor also rejected suggestions that we had acted irrationally or unfairly. In fact, in the penultimate paragraph of the judgment he states: 'I can see no basis on which the manner in which the Directors exercised their ... discretion can be categorised as irrational. I can see no irrelevant factors that they took into account or any relevant factors that they should have taken but failed to take into account.' "

The Vice-Chancellor had, however, granted leave to appeal. The Society said that it would meantime maintain its approach to bonus rates for with-profits policyholders.

77. The Court of Appeal reversed the decision. On 20 January there was a conference to discuss the result and the draft opinions then available. Green commented on the opinions. In his view it was significant that the two Chancery lawyers who had examined the issue, first the Vice-Chancellor and then Lord Justice Morritt in the Court of Appeal, had both sided with the Society in the result sought. However, he expressed disappointment that the Society's argument on 'related bonuses' had been rejected, especially by the Vice-Chancellor and Lord Justice Morritt.

78. The second major point made was that although finding against the Society, Lord Woolf and Lord Justice Waller were unable to agree with each other as to their reasons for allowing the appeal and reversing the decision of the lower court. Green discussed the weaknesses of Lord Woolf's opinion. Of the nine reasons given by Lord Woolf, it was said, some seemed irrelevant and the remainder were unconvincing. Lord Woolf did not understand the arguments put forward by the Society. Lord Justice Waller had adopted an extraordinarily legalistic approach to the whole exercise. In Green's view, the judgment bore the hallmarks of a judge unable to "see the wood for the trees".

79. Green advised that leave be sought to appeal to the House of Lords where he thought the Society would win. Since the matter originated in the Chancery Division, Green said it was likely that the panel would consist primarily of Chancery lawyers, who in his view would be heavily influenced by the fact that the two Chancery lawyers who had examined the matter to date had decided in the Society's favour. There was extensive discussion of the position pending an appeal to the House of Lords.

80. On 1 February the Society sent policyholders a further circular letter signed by Nash. It announced that the Court of Appeal had overturned the High Court decision by a majority of two to one. The letter followed counsel's advice, but cannot be paraphrased:

> "Taking the High Court and Court of Appeal hearings together, two Judges have found in favour of the Society, and two against, with different reasoning being advanced in the case of the two judgments against us. I am disappointed by the Court of Appeal decision and am sorry that the clarification and certainty which we sought for our policyholders when we initiated this action have not yet been achieved. I am, however, pleased that the Court of Appeal has recognised the importance of this case by immediately giving the Society permission to appeal to the House of Lords and by agreeing that the matter should be dealt with urgently. The Court has also made it clear that the Society's current approach can be continued pending the result in the House of Lords. We shall therefore be maintaining our current approach to bonus rates for with-profits policies. ..."

81. The opinion of Lord Justice Waller, at paragraph 135, provided comfort to the Society where he stated:

> "It is possible that because there is no contractual entitlement to a final bonus, and because as between different types of policy it is certainly, in my view, legitimate for the board to have regard to the value of the notional asset share of the different policyholders, the guaranteed annuity rate policyholders will not in actual cash terms do very much better than they have done under the differential bonus scheme. I see no reason why different bonuses may not be awarded to different types of policyholder and thus I do not understand why, for example, the board cannot in deciding what final bonus to award to G.A.R. policyholders, keep that bonus at a level which does not deprive different with-profits policyholders of their equivalent asset share..."

Thus the possibility of a ring-fencing solution was referred to in the judgment. In some later observations Equitable sought support for ring-fencing from certain observations in Lord Woolf's opinion. However, in the written case to the House of

Lords, in which counsel of necessity focused on the support that was available for the Society in the opinions of the courts below, Equitable correctly relied on Lord Justice Waller's observations alone.

82. On 26 January 2000, the Board decided, on the advice of the Society's solicitor, to change leading counsel for the Lords. The reason was said to be the change in the character of the case, which now related more to Chancery issues. On 16 February the Society's advisers and officers discussed the scope of the appeal to the House of Lords. Elizabeth Gloster QC had been appointed leading counsel, and the discussions covered the lines of argument available on the contract documents and the approach she wished to take in argument. Gloster was anxious to be able to found her arguments on the principle of mutuality, in her view: "the beginning and end of it", according to the minute. In a pre-meeting with the solicitors only, she also questioned, in the light of the Court of Appeal judgments, whether there could be any doubt that the Society would be able to ring-fence.

83. There was a further conference on 7 March. On 14 March and 23 March there was discussion of the statement of facts for the appeal. Dentons' attendance note of the meeting on 23 March contained observations of some materiality in assessing the approach adopted in the House of Lords. The note stated:

> "1. There was some discussion as to the recent discussions with the Society as to the make up and running of the with-profits fund. It has become apparent that the Society do not consider there to be one with-profits fund in practice at all, rather, the fund is notionally hypothecated between its various constituent parts. What is more, different rates of final bonus are awarded as between the various separate notional funds and accordingly the asset shares of the members of each notional part vary.
>
> 2. ... EG raised the point that there is in fact a subdivision within the GAR class between those who take their benefits in GAR form and those who take their benefits in fund form. It is highly material whether Sumption is seeking to argue that the matter should be ring fenced to GAR policyholders or that final bonus should be averaged across the various classes.
>
> 3. EG said that in her discussion with AL [junior counsel] the previous week he had indicated that he believes Sumption is definitely arguing that the same level of final bonus should be awarded across the GAR and non-GAR classes. EG pointed out that throughout the case Sumption's arguments have tended to be somewhat ambiguous and he has not focused on the distinctions between the classes. EG wants to rely on Waller's point that he sees no problem with the aim of preserving asset shares provided the approach is consistent with the terms of the specific policies."

Mutuality across the with-profits fund had clearly become problematical in view of the Society's actual practices in managing the with-profits fund and discriminating between policy groups in relation to bonus allocation. It is not immaterial, in view of some later criticism of the House of Lords' decision, that Gloster's initial intention had been to emphasise mutuality as the core issue in the case. As the Society's practices were now understood, the scope for ring-fencing of annuity guarantee liabilities began to emerge as a significant factor.

84. Various procedural issues were discussed, including the scope of the representation order. Gloster thought that the order had been incorrectly drafted and that Hyman could not possibly represent both GAR policyholders who have taken benefits in fund form and GAR policyholders who had taken the GAR based annuity. There were in effect three classes of policyholder, not two. As the earlier narrative has shown, the number and classes of policyholder to be represented were issues that had been debated at length in the initial stages of preparation. Gloster's view was hardly new. But the more significant point is the appreciation, apparently as a matter of some novelty, that the Society had not been awarding bonus on a level basis across the with-profits fund, quite apart from the differential final bonus

policy. The point was taken up in a fax from the solicitors to counsel on the same day, 23 March:

> "In this context I should add that during the discussions with the Society about the Statement of Facts, it has transpired that in deciding upon the different final bonus levels, regard is had to asset share in the light of the particular type of business being written. ... This has not been reflected in the proceedings to date. Since the Statement of Facts refers to different final bonus levels and different classes of policy, I suspect that either Sumption will refer to it in his Case or you may be asked questions about it by the House of Lords, assuming that no explanation is contained in our case."

85. The topic was resumed on 30 March. The solicitors' note of the consultation with counsel stated:

> "1. EG said her primary concern was whether the affidavit evidence sworn at first instance misrepresented the position as regards the make up of the with-profits fund. Paragraph 3 of CPH's [Headdon's] note refers to four notional sub funds. CPH confirmed that the Society's balance sheet consolidates the various notional sub-funds .... EG wondered to what extent the sub-funds are actually notional and CPH replied that the sub-division is never reported to the outside world. In terms of calculation of asset share however, certainly it is true that the sub-division is not notional."

In addition, Headdon told counsel that separate actuarial tables were used for each fund, for example German actuarial tables were used in Germany. It appears clear that Gloster's intention to rely primarily on mutuality had been undermined by the Society's practice of creating sub-funds within the with-profits fund which, though described as notional, were in fact the basis of practical distinctions in relation to bonus allocation.

86. On 18 April, the ring-fencing issue came to the fore in discussion:

> "6. Leading Counsel said that she definitely wanted the ring fencing point raised in the Case. If we are silent on the point in our Case we run the risk of the point being raised by one of the Judges in the Lords. If the point is glossed over and not dealt with at all at the hearing, there is a clear risk of further litigation, were a disgruntled policyholder to maintain that the Society, although having succeeded in the Hyman action, was not entitled to differentiate between GAR and Non-GAR policyholders.
>
> 7. Provided the point is raised then we can ... maintain issue estoppel in any future litigation. CIML mentioned that Andrew Lenon [junior counsel] was undertaking the task of checking through Sumption's Submissions and skeletons at first instance and in the Court of Appeal to confirm whether he had ever suggested that the Society cannot ring fence."

87. By 6 June all was prepared: there was extensive discussion of tactics for the hearing, and of the lines of argument to be pursued. There was, in particular discussion of the ring-fencing issue:

> "14. Next, CJM [Matthews] raised the ring fencing issue. He explained that obviously the Society were in the midst of their contingency planning. It seemed inconceivable to him that the Court could possibly hold that only one level of final bonus should be paid to all policyholders, irrespective of the class of policy held. Sumption had not indicated how this might be achieved. EG agreed that Sumption had developed the point in a weasely way. It would be interesting to see how he argued it in Court. He had of course made no cross-appeal directly from the Waller point (see paragraph 135 of his Judgment) to the effect that it would be perfectly permissible for the Society to ring-fence.
>
> 15. In this context EG mentioned that on further review she had noticed that paragraph 5(5) of Sumption's Notice of Appeal to the Court of Appeal in effect raised the ring-fencing argument. Moreover there were really two points-

first, whether it was permissible for the Society to pay a lower final bonus for all GAR policyholders and second, whether it was permissible for the costs of the GARs to be borne across the board. Obviously Chris Headdon's note detailing the commercial arguments should be very useful. This had been utilised in the Society's Case.

16. CIML thought that CPH had recently indicated that if ring-fencing in the desired manner was not permissible then as a fall back be would prefer to spread the cost of meeting the GAR pensions throughout the B1-9 class. CJM said that he did not think this was correct. He explained that there were serious differences between bonus rates for various categories of policy depending not only on investment terms but also on taxation. A good example was the personal pension plan which was untaxed business. An equivalent such as the personal investment policy (which was taxed business) received a lower bonus rate than the personal pension plan class. The difference arose because in the case of the personal pension plan, before the policyholder received his benefits he obtained an untaxed "roll-up". When he bought an annuity he would be taxed on a PAYE basis. Thus declared bonus for a PPP may be 12%, whereas for a personal investment plan it may be 10%.

...

18. It was agreed that come what may, the Society would like the ring-fencing point decided. It did not want to be left with the uncertainty which followed the Court of Appeal decision. Whereas it had then been possible to obtain a stay, it would not be practical for the uncertainty to continue now. EG thought that the fact there were a variety of reasons for differential bonuses, as brought out in the various resolutions, was a critical point which she fully intended to raise in opening. CJM said he was very pleased by this."

Resolution of the ring-fencing issue had come to be central to the Society's interests.

88. Nash had anticipated the possibility of a ring-fenced solution in his first affidavit: paragraph 750, where there was a statement of the Society's fall-back position on ring-fencing. Conscious as the Society's advisers were of the importance of laying a basis for issue estoppel, the observations were clearly not casual. Equitable were responsible for introducing this factor into the case, albeit not in the statement of the issues focussed in the originating summons. It is clear from Gloster's views at the conference on 18 April 2000 that she wanted the issue dealt with, and that remained the position until the hearing. The issue was focused in the written case to the House of Lords at paragraphs 117 to 121. It was dealt with briefly in the respondent's written case also.

89. At the end of the consultation on 6 June, Gloster repeated her opinion that the Society ought to win on the contract issue even if it lost on the 'related bonus' argument (see paragraphs 46 and 47 ante). She said that the inevitable problem with that argument was that Lord Justice Waller, a respected judge, was against the Society, and there were difficulties on the language of the contract. However, the Society should, she said, go on assuming that it would win.

90. The House of Lords rejected the appeal. On 2 August 2000 Nash sent policyholders a further letter. He stated:

"In essence, the House of Lords ruled that The Equitable is not entitled to give a different level of final bonus to those policyholders who take their benefits using GARs.

The ruling means that The Equitable is required to increase benefits for some policies with a corresponding reduction in the benefits of other policies. One of the aims of the sale of the business is to restore reduced benefits to the previous levels."

91. Because of the approach adopted in specifying the issues to be dealt with in the action, some questions of interest were not considered by the courts, even on the

facts agreed. The House of Lords did not consider how the Society had handled, or should have handled, situations in which an annuity guarantee policyholder elected to transfer benefits into other schemes, for example. Generally, the policy form selected for the litigation did not allow of debate on the earlier contracts, which might have been more favourable to the annuity guarantee policyholders. These and other limitations are inevitable where parties select the issues for debate. The Society sought seriously to curtail inquiry by careful definition of the initial issues, and by seeking to constrain Hyman. However, in the end Sumption's strategy and arguments prevailed.

Contingency Planning during *Hyman*

92. Throughout the proceedings, the Society prepared contingency plans, seeking to identify the range of possible results and to prepare to respond to them. The assessment of the probability of one result as against the others engaged the attention of management and of advisers alike. It is relevant to note in this context one course of action that was proposed and rejected at the outset. On 28 January 1999 Cindy Leslie of Dentons wrote to Matthews. She proposed that the Society should consider setting up a new ring-fenced with-profits fund to receive new money in relation to new policies and, possibly, existing policies. The letter stated:

> "I have been pondering what additional steps could be taken by the Society to make new investments in the Society more attractive to existing and prospective policyholders. Of course I appreciate, as John Weller forcefully pointed out at Tuesday's meeting, that criticisms of the Society in the media and elsewhere inevitably cause anxiety and/or uncertainty amongst some policyholders as well as a reluctance on their part to invest more money.
>
> Apart from a general reluctance as referred to above, policyholders who do not have GARs and who think that the Society might lose the test case may fear that new money put into the Society will be used to finance unfair final bonus payments to GAR policyholders. Alternatively policyholders, whether with or without GARs, may think that if the test case is lost, their final bonuses will be cut.
>
> I appreciate that the Board is currently of the view that if the existing "equalisation policy" is held by the Court not to be a proper exercise of the Trustees' discretion, the adjustments to final bonus which will have to be made should, as a result, only apply to GAR policyholders. However, as I mentioned at Tuesday's meeting, it is possible that the Court may not agree that differentiating between GAR policyholders and non-GAR policyholders in this way is proper.
>
> In order to seek to mitigate the effect of these points, may I suggest that the Society gives consideration to setting up a new ring-fenced with-profits fund to receive new money in relation to new policies and possibly (subject to what is said below) existing ones as well. If, contrary to your legal team's view, the test case were to be lost, that fund would not be affected by the decision of the Court. Only the existing with-profits fund would be so affected, whether as regards all policyholders or simply GAR policyholders. Ring-fencing of new investment could be a useful selling point. It could also provide a measure of reassurance to new policyholders, and perhaps existing policyholders as well.
>
> Such a step could of course be seen as a weakening of the Society's confidence in its case. I hope, however that the true rationale for such a move can be put across successfully to the media and to policyholders direct. I assume it would be too much to hope that it be accepted as yet another initiative by the Society to ensure fairness of treatment among policyholders. ..."

93. The proposal was referred to further by the solicitors at later stages. It was not pursued by the Society. It is material to the interests of some policyholders that the

issue was focused for the Society at this early stage, and in such clear terms. The Society's solicitors had offered a possible solution to the problems that were eventually to emerge in the case of late-joiners and others who made late contributions to the undifferentiated with-profits fund. There would have been difficulties implementing the proposals, but, in the event, contingency planning took a different route, reflecting the confidence of the Society in the strength of its case.

94. On 18 February 1999, Headdon wrote to Dentons setting out a range of contingencies and proposing procedural and substantive steps in response to them. The solicitors responded on 12 March, 1999. There were further exchanges on 12 April 1999 and 17 June. In July the general form of the final range of scenarios identified while the case was at first instance emerged.

95. Six scenarios were identified, which were:

1. Complete success;

2. Success but with some adverse comment in judgment;

3. Directors had discretion but had incorrectly exercised it on technical grounds, eg PRE, but the Court did not interfere because the error would not alter Board's decision;

4. Directors have discretion but had not considered or given sufficient weight to the right factors, or had considered irrelevant factors, and the Court considered that they might, if they did so, reach a different conclusion;

5. The Society's approach to equalisation of benefits in the interests of fairness was invalid and that final bonus rates on cash and annuity benefits on policies with GARs must be equal, but that the Board still had discretion to set differential rates as between GAR and non-GAR policyholders as they deemed appropriate (ie the option of 'ring-fencing' would be available); and

6. The Society's approach was invalid and that final bonus rates on cash and annuity benefits must be equal in relation to all relevant with-profits policies, whether with or without GAR provisions in them.

In the first 3 scenarios there would be no need to change the bonus policy, although the prospect of a surge in retirements and surrenders was noted under most scenarios. Scenario 4 would require an immediate reduction in final bonuses to nil until new rates could be determined or the previous rates confirmed. There were proposals for dealing with those who retired in the interim. Should the Board decide to change its bonus practice, then the action would be as for scenario 5 or 6.

96. Following on the description of the scenarios, work was being undertaken by ACTV (the actuarial valuation team) on reasonable bases for new bonus rates to be applied back to the date of the judgment in the event of scenarios 5 or 6. Work was also underway to identify all the relevant GAR cases that had retired under the differential terminal bonus policy with a view to compensation.

97. The contingency plan had been reduced to the six scenarios that, broadly, remained intact thereafter while the case was at first instance. Some collateral issues had been omitted. In addition, particular potential problems had arisen for discussion. In June 1999 the risk of mass 'surrenders' or transfers was discussed. The Society was advised by its solicitors by letter dated 17 June 1999 that the policies did not entitle the policyholder to transfer, and that, unless the Society had stated otherwise so as to create PRE, the Society therefore had control of timing, and of transfer value.

98. Alternative scenarios to test the Society's response were proposed and revised. An important issue was the risk of high volumes of transfers by non-GAR policyholders. Market value adjustments were discussed. The calculation of surrender values was discussed at length.

99. Following the Vice-Chancellor's decision at first instance, policyholders' reasonable expectations became a more significant issue. At a conference on 11 November 1999, counsel commented under reference to the judgment of the Vice-Chancellor in the *Hyman* case:

> "Counsel explained that the Vice-Chancellor's judgment is the only judicial interpretation of the role of PRE in the exercise of discretion by the directors of a life office and its interplay with policyholders' contractual rights. What the Vice-Chancellor appears to be saying is that policyholders have legitimate expectations above and beyond their contractual rights that the life office concerned will act reasonably and with consistency according to its own past practice and general past practice in the industry. Reasonableness and consistency are therefore two key watch-words to be drawn from the Vice-Chancellor's judgment. If the life office acts reasonably, fairly and consistently, the court will not interfere with the exercise of the directors' discretion. In considering whether a particular course of action is indeed reasonable, fair and consistent, Counsel emphasised that he is able to advise only as to his view of the relevant parameters. The decisions that are ultimately taken are matters for the Society."

100. The Vice-Chancellor's decision did not require further planning on the main contingencies identified, and there is little evidence of the topic engaging the Society or its advisers prior to the decision in the Court of Appeal. The Board considered the decision of the Court of Appeal at a meeting on 21 January 2000, the date on which judgment was delivered. At that meeting it was reported that the Court had agreed that the Society could maintain its current approach to bonuses. The Society's solicitor stated that Counsel were confident of success in the House of Lords, although no guarantee could be given. The directors acknowledged that there were risks, but concluded that an appeal should be made to the House of Lords. The board resolved to continue its pre-existing terminal bonus policy, aware that if it lost in the House of Lords there would have been excessive payments to some policyholders that could not, in practice, be reclaimed by the Society, and that there would be a liability to make up the shortfall in payments to others. The minutes stated:

> "Final Bonus Rates
>
> The General Manager - Finance and Appointed Actuary, Chris Headdon (CPH), ... commented that, at the Society's request, the Court of Appeal had agreed that the Society could maintain its current approach to the allocation of bonuses until the outcome of the House of Lords ruling had been obtained. This avoided the adoption of a change of approach which might subsequently be proved to be unnecessary. The Society had given an assurance that, if the House of Lords agreed with the Court of Appeal and that meant that any policy maturing between the present time and the House of Lords' ruling would have received higher benefits, additional sums would be paid in relation to such a policy. CPH confirmed that it was his firm recommendation that the appropriate course of action at the present time was to maintain the current final bonus rates. Although no Board resolution was required to put this into effect, it was important that the Board had fully considered the matter and affirmed or otherwise their agreement to his recommendation.
>
> There was discussion of CPH's recommendation. It was recognised that, should the Society succeed in the House of Lords as it expected, revision of the Society's approach at the present time would have been unnecessary. It was noted, however, that should it be necessary to revise the Society's approach following the House of Lords ruling, any sums paid out to policyholders in excess of those which would have been derived under the revised approach could not, in practice, be reclaimed by the Society.
>
> Recognising that, in the Society's view, its current approach to setting final bonus rates was designed to ensure, as far as possible, that each with-profits

policyholder received his or her fair asset share, and taking into account the matters discussed, the Board affirmed that current final bonus rates should be maintained."

101. On 26 January 2000, the Board proceeded to declare bonus rates in respect of the year ended 31 December 1999 at the same level as applied for 1998, with a total growth rate of 12% for United Kingdom pension business and equivalent rates for other classes of business. Contingency planning progressed on 28 January, when Headdon sent to Leslie a more developed 'fall-back' position for speedy implementation if the House of Lords 'sided' with the Court of Appeal. In his covering letter, he wrote:

> "I have been giving further thought to our likely fallback position should the House of Lords side with the Court of Appeal. I believe, on this occasion, it is vital that we have a well-developed approach 'on the stocks' ready for speedy implementation. That indicates the desirability of tackling that now so it does not conflict with the hearing preparation at a later date.
>
> In the attached note I have tried to set out the issues where I feel we need advice. ..."

102. The appendix to the letter set out the fall-back position:

> "1. The Court of Appeal ruling has led the Society to consider in more detail than previously a possible fallback position. The indications given by L J Woolf and L J Waller of the way they might expect the Society to react, have concentrated attention on a route which was first considered several months ago. We intend now to develop that in more detail. The purpose of this note is to set out some initial issues on which legal advice is required.
>
> The approach in summary
>
> 2. The approach can be summarised as having 2 main elements:
>
> (i) the setting of the common rate of final bonus at the lower level which currently applies if benefits are taken in GAR form and
>
> (ii) offering those GAR policyholders who do not want to take benefits in GAR form an 'opt-out' whereby their policies are endorsed effectively to remove the GAR and, thereafter, they receive the 'fund' level of final bonus (as applies to personal pensions and other comparable contracts without GARs).
>
> 3. That approach has the following advantages:
>
> (i) there is no additional cost falling on other policyholders
>
> (ii) GAR policyholders can continue to have alternative benefits of full value (albeit with a little less freedom of choice than previously)
>
> (iii) if a significant proportion of policyholders choose the opt-out the additional statutory GAR reserves would be substantially reduced
>
> (iv) such a course would support the contention that all that is 'wrong' with past claims is that policyholders not selecting the GAR have been 'overpaid' and there is, accordingly, no question of compensation.
>
> The disadvantages are essentially of a PR nature and are not relevant to this note.
>
> 4. It has been assumed that the opt-out would need to be for a limited period only because a running option would effectively give the same position as at present and would seem to be a blatant contravention of the will of the court. Advice is sought as to whether or not that assumption is correct. If it is, advice is sought on the appropriate length of period during which to offer the opt-out - from a practical point of view a period such as 6 months would be

reasonable. [As an aside it is worth noting that a limited period is attractive to the Society as it is likely to maximise advantage 3(iii) above.]"

Clearly this fall-back depended on ring-fencing being an option that it was open to the Society to adopt. He proceeded to analyse the form of bonus resolution required to implement the proposals, commenting on the notes that would be required, and proposing draft terms for them. He invited comments. The questions focused by Headdon were commented on briefly by the solicitors on 10 February 2000, but the substantial issues were left over for discussion at consultation planned (according to the agenda) for 16 February. Item 3 on that agenda raised the possibility that the House of Lords might strike down ring-fencing.

103. Meanwhile Martin, the vice-president, wrote to Headdon on 12 February raising concerns about contingency planning. He warned of the unpredictability of the outcome of the House of Lords' case. As an experienced lawyer, he reflected a proper appreciation of the scope for variations of view, and warned of the need to consider different practical consequences from those elaborated by the actuarial team. He was apprehensive that Nash had made statements to the media that underestimated the risk.

104. A reply was delayed until after the next meeting. As mentioned in paragraph 82 above, on 16 February there was a lengthy consultation with counsel. At a pre-meeting with the solicitors, counsel queried whether there was any doubt that the Society was entitled to ring-fence GAR policyholders as a class. She had taken it as a given in the Court of Appeal's judgments that the Society was entitled to differentiate between GAR and non-GAR policyholders. This was agreed. However, it was said to be a different issue entirely whether policyholders realised the significance of this. It was understood that another case could theoretically be launched calling into question the discrimination between classes. .

105. Equitable's management explored with counsel the risk of damages claims against the Society. Counsel warned that the House of Lords would not be interested in 'cheap' arguments that focused on the impact on the Society of an adverse decision. There was detailed discussion of the legal bases on which claims might be made. The discussion then covered the possibility of unravelling annuities already in payment. Headdon told counsel that approximately 80% of those who had taken their benefits had chosen an alternative annuity with the Society as opposed to taking benefits elsewhere. In relation to the minority, the advice was that Equitable could not assume that other insurers who had received funds from the Equitable would be willing to repay those funds (less expenses) in the event of the Society maintaining that they had been overpaid, as had happened in another case. In the absence of a similar concession from third party insurers, the Society would not be able to rescind or avoid the previous transfer of funds. The issue remained live only in respect of the Society's own annuitants. The advice was that they had a range of defences open to any claim, and the PIA might in any event intervene.

106. Discussion at the meeting then turned to a proposal by Headdon that annuity guarantees be removed by agreed endorsement. It appears that the motivating factor in proposing the endorsement was the desire to reduce reserves for GAR policies. Legal advice indicated that it would be very difficult for any given policyholder to make an informed choice until he or she reached selected pension age. The Society's solicitors proposed an alternative form of endorsement. Gloster strongly advised that no endorsement should be brought into effect until after the House of Lords had ruled on the matter. It was possible that the Lords might find that directors had exercised their discretion for an improper purpose. That could undermine the implementation of any endorsement of the type envisaged.

107. On 22 February, Leslie commented on Martin's letter of 12 February. She discounted most of his concerns. If Equitable won the case, there would be a revival of earlier claims and others might surface. Most of them would be without substance. The House of Lords would not be able to reject the 'asset share' theory. It was a relevant factor for the Society and the industry as a whole. She stated that

Gloster had advised that the decision would have direct affect only in relation to annuity guarantee policyholders. Final bonus would remain a matter for the directors.

108. On 17 March 2000 the solicitors wrote with a fresh statement of the scenario planning pending the House of Lords case. There remained six categories, generally along earlier lines, but with grater specification of the action required in response. The covering letter indicated that the probability of some of the scenarios had diminished.

109. There was a meeting on 24 March to 'brain storm' the position in regard to possible endorsements to alter policy conditions and other issues that would arise should the Society lose in the House of Lords. The revised scenarios were discussed starting with scenario 6:

> "The point was raised as to how the cost of guaranteed annuities should be spread (on the assumption that the House of Lords might say that when setting final bonus rates the Society is not entitled to allocate this costs to the GAR policy holders alone). The initial thought was to spread it amongst the "B9" class of UK pension policies. Chris Headdon queried why this should be the case rather than applying it across all with-profits policies on the basis that it was a cost of the business and therefore it should be born by all the members. However, the wider the burden is spread the less the reduction for each GAR policy and thus the better GAR policy holders do as their own final bonus is reduced less. The more the argument was taken forward the more it seemed absurd that the Court should be permitted to stipulate how the cost should be born. There were many current examples of specific costs/benefits being born by/attributed to particular subclasses of policyholders for example the "minor profits" class, the class of policy holders who are in a tax free fund and therefore will receive a higher share of profit based on the tax free fund and the "loan back scheme" policies. It seemed that we could construct sufficient arguments (should the Court be invited to think about specifying how the discretion should be used) to show the absurdity of the potential result which could be ultimately to throttle the ELAS business. In addition where would the Court's directions on discretion stop? If the Court held that the cost should be borne in a particular way and the final bonus had to be reorganised accordingly would this for example preclude the Directors in future years allocating a lower rate of final bonus to GAR policy holders than to other pension or with profit policy holders on the basis that the GAR policies included other favourable terms (namely the GARs)."

110. A range of other consequential issues arose for discussion. There was apparent confusion over some issues:

> "There was a discussion before Chris Headdon arrived as to how the "GIR" [guaranteed investment return] worked and the fact that it was not taken off declared bonuses but adjusted in final bonus which meant that (a) the annual statements were incorrect or misleading when they refer to eg declared bonus of 1.5% when they mean 5% but a lower final bonus, (b) if final bonus is cut to zero the policy PAV [premium accumulation value?] may be uncomfortably large, (c) is the reduction to 1.5% mentioned at (a) correct anyway, given that the 3.5% GAR relates only to contributions paid not to the whole guaranteed fund would include declared bonuses added over the years."

Even at this late stage, the Society's procedures had failed to avoid, or dispel, totally an aura of mystery so far as the advisers were concerned.

111. The possibility of directors having to resign in the event of failure in the case was raised at conference on 18 April 2000. Gloster said that she saw no legal reasons for the president or the directors to resign. She said that the Board had acted entirely properly throughout. The representative proceedings were issued in a thoroughly reasonable attempt to obtain legal clarification of the position. The fact

that they had proceeded without legal advice on the issue until 1998 was neither here nor there. Whether there were commercial reasons compelling a "sacrificial lamb" was another matter entirely on which she said she could not comment. The process that led to the departure of Alan Nash had begun.

112. On 20 June, there was a conference following the hearing. Scenario planning was now concentrated on numbers 5 and 6. As updated, Scenario 5 dealt with the situation where the Society lost but the Lords permitted "ring-fencing" of the cost of any additional benefits within the GAR class of policyholders. Scenario 6 reflected the position where no ring-fencing within the GAR class was allowed, but the Society was permitted to contain the cost within the class of policies falling within the B9 bonus resolution. Leslie added that a further scenario - scenario 7 - was being added, whereby the Society lost and was not permitted to contain the cost within B9: Sumption had argued for a scenario 7 outcome. As before, the actions required in response to the various scenarios were not intended to cover ancillary matters such as PR, reinsurance, demutualisation or any changes to the articles.

113. In other respects, there was extensive discussion of the implementation of scenarios 5, 6 and 7. The setting of a new final bonus level in scenario 5 would require justification. The Society was to consider proposed policy endorsements, in particular to allow annuity guarantee policyholders to opt-in to the present differential bonus system. Approval from the Revenue had been obtained in relation to endorsements of the two most popular policies and was awaited on the others. The legal advisers all expressed concern about the legal viability of this route. Their concerns were that in offering the contractual variation to the annuity guarantee policyholder class the directors might be found to have exercised their discretion in order to favour one category of policyholders over others and produced a situation where there were differential final bonuses within the annuity guarantee class. Leslie explained that Brian Green and Simon Brown had advised on the point in general terms, but before the hearing before the House of Lords. It was agreed that a written opinion should be obtained from Green.

114. Claims by those who had taken benefits since the equalisation policy was implemented in 1993 were discussed. Approximately 35,000 policies had matured in the material period and of these, in only around 1,500 cases had individuals elected to take benefits in annuity guarantee form. Quantification would depend on the revised final bonus rates. Cindy Leslie emphasised the importance and urgency of clear legal guidance as to the Society's legal position if scenarios 5, 6 or 7 applied. It was therefore agreed that counsel would prepare advice on:-

"(a) the various type of claims which may be brought against the Society by individual policyholders, whether in contract, under statute or otherwise;

(b) potential defences to these claims which may be available to the Society (e.g. contractual defences such as accord and satisfaction, limitation defences);

(c) quantification of damages in each category of claim;

(d) whether it may be possible in theory for the Society to claw back overpayments to certain policyholders; for example those taking benefits in fund form may have been overpaid."

It was understood that the PIA Ombudsman would be likely to insist on a scheme of compensation to be devised in the event of an adverse judgment, and in any event the Society would wish to set out a formulation for a compensation scheme as soon as it could, subject to the various defences open to it. This laid the foundation for the development of the 'rectification scheme' proposals dealt with separately in this report[17].

[17] See chapter 8, paragraphs 9 to 32.

115. For present purposes, a scheme of compensation was seen as an essential element of the response to failure, independently of what other steps were required. Leslie advised that if the result were adverse, the Society should produce, and be seen to be able to produce, its plans for compensation in a coherent, comprehensive and appropriate way, and to use the Court to seek approval for its plans so that all relevant policyholders would be bound by them. At this initial stage a court-approved scheme was envisaged. It was generally agreed that at all events compensation issues would be better dealt with under the umbrella of the existing proceedings rather than under new proceedings. Apart from keeping Hyman and his legal advisers in place for as long as possible, in order that the benefits of continuity were obtained, there was the added advantage that it might enable the Society to ask the PIA Ombudsman to defer reactivating claims currently stayed. Moreover, for a compensation scheme to have any value it should be made subject to binding representation orders which required remitter to the Chancery Division. The Society and its legal advisers now expected failure in the case, and prepared for the future on that basis.

116. On 4 July, Peter Sedgwick, deputy chairman of the Society, contacted Michael Foot, managing director responsible for authorisation and supervision at FSA, to report "straws in the wind" that the Lords "would like to find against the Society". He said that the main concern was the level of sacrifice that might be needed. John Sclater, the chairman, and Nash wished to resign if the decision went against the Society, but Sedgwick was concerned that this might be unnecessary if the House of Lords were not critical of the Society's conduct, and might reduce the ability of the executive to deal with whatever transition was necessary. Having consulted his own chairman and the head of insurance at FSA, Foot responded the following day to say that FSA agreed that there was a concern about continuity, though the situation would depend on the detail of the judgment. But on what they knew at that point, it was "unlikely that the FSA would be throwing brickbats at Equitable Life".

Conclusion

117. As I said in the foreword, it cannot be for an inquiry like this to review the decision of the House of Lords, as many of those who have approached the inquiry have sought to persuade me to do. The courts settle the questions before them, on the basis of the arguments that are put to them. It is for the parties to select the grounds on which they choose to contest issues. The questions posed inevitably change and develop in focus in the course of the litigation. Within the framework of the written case counsel react to the approaches adopted by opponents and to the Court. But, at the end of the day, the decision of the House of Lords was final on the issues that were referred to the Appellate Committee for judgment. That is the nature of our civil justice system, and those affected by the decision must accept it.

118. In view of the many representations I have received, in particular during the maxwellisation process, to the effect that the *Hyman* decision was wholly unexpected, and could not have been anticipated in any way, it seems appropriate to say that any impression that the industry as a whole supported Equitable's stance, or that legal opinion was universally in favour of the Society, is wrong. I am satisfied that I have reliable information that within the industry there were those who considered the position adopted by Equitable, and the few other offices who adopted similar practices in relation to differential terminal bonus, to be quite untenable. There were also lawyers, not involved in the case, who expressed views contrary to the advice Equitable received, before the House of Lords delivered judgment. I offer no view on the merits of the respective contentions. But I must dispel the notion widely advertised by the representations made to me, and in the public domain, that *Hyman* was a decision beyond reasonable contemplation.

119. The House of Lords decision can be reduced to a relatively simple proposition. No discretion granted to the directors in the constitution of the Society could enable them to frustrate the clear terms of their contracts with the GAR policyholders:

explicit contractual benefits could not be overridden by the exercise of managerial discretion. Those who have been critical of this judgment, and I have received many critical representations, need to consider whether they would have been prepared to purchase a pension if they were informed that the management might from time to time sell policies with different terms that potentially gave members of the same fund sharply divergent interests, and that should it emerge in the future that there were members of the same fund who had less advantageous terms (in the circumstances of the time), the terms of their own contract could be overridden at the absolute discretion of the board. Most potential policyholders might pause before entering into such a contract if the realities were fully explained. The decision in the case was never likely to please all interested policyholders. But disappointment at the outcome of litigation, never an exact science, is not a valid basis for criticism of the result.

120. The Board of the Society has been criticised for entering into and prosecuting the litigation. I can see no reason to criticise the Society's Board or executive management for taking steps to test the legal issues that had arisen. There were real issues to try, and one would have been concerned rather by refusal to confront them, and by any attempt to avoid exposing them to debate before the competent civil courts. There was a degree of surprise expressed within the industry at the final ruling. But professional opinion was divided even before the case was finally disposed of. Had the Society ignored the issues, and been brought into court by a policyholder, one must assume that the same result would have been arrived at: the law does not vary according to who initiates the case although the formulation of the issues may.

121. The legal advice the Society obtained at some stages did highlight certain risks. For example, the solicitors highlighted at an early stage the lack of disclosure in the policy conditions that the differential terminal bonus policy would apply, and the failure to distinguish between 'related bonuses' applying to guaranteed and current annuity rates. As I have noted, the assessment supplied by Dentons to the Society on 7 September 1998 was a reasonably balanced view of the issues likely to confront it in the course of the litigation. However, the tenor of the advice throughout was that the Society had a strong case and when the litigation was initiated, there was a sense of real confidence.

122. Once the litigation was underway, however, it became increasingly apparent to counsel that some of the grounds on which the Society might have sought to defend its position had been made untenable by its own practices in relation to the management of the with-profits fund and, in particular, the allocation of bonuses.. The argument that, within a single fund, equivalent benefits should accrue to equivalent investment, taking account of variations in contractual terms, might have been held to be an essential part of mutuality, a principle that the Society had long claimed to be guided by, if the argument had been available. But it appears that that was just one of the myths promulgated by the Society about itself that have become evident in the course of this inquiry. In practice, for example, German policyholders had been given returns reflecting the performance of German assets, when otherwise the business was treated as part of a single with-profits fund, a practice that appears to have been adopted for marketing reasons rather than reasons of high principle.

123. The *Hyman* case focused issues that could only be resolved by a court of competent jurisdiction. They were issues of law about which competent and experienced lawyers could entertain and express differing opinions. It is important to observe that these issues did not arise in a vacuum, nor as matters of theory. They arose from the actual practices of the Society in dealing with the rights and interests of policyholders in the economic circumstances that confronted management. The issues had to be resolved.

124. Actuaries, whether the Society's actuaries or the actuarial profession as a whole, were not competent to adjudicate on the issues that emerged. If there is any

criticism of the Society's management it is that they did not confront the legal issues much earlier than they did. The development of policy, in relation to product specification, the ascertainment of surplus and distribution in particular, are dealt with later in this report. There were many stages in the Society's developing business at which the issues eventually dealt with in *Hyman* could with advantage have been tackled and resolved. Had the Society acted earlier, the problem might have been contained and managed. Many policyholders might have been spared loss. In the next chapter, I shall identify some of the stages at which the issues might have been raised.

CHAPTER 2: ORIGINS OF ANNUITY GUARANTEE ISSUE

1. The story of how the Society arrived at the position in which it found itself in July 2000 has many aspects. It is appropriate to discuss in this chapter the evidence available on the origins of annuity guarantee policies, the Society's annuity guarantee policy forms and premium bases, and the evolution of the differential final bonus policy, as topics that bore on the issues in the *Hyman* litigation.

Origins and Nature of the Annuity Guarantees

2. In general terms, retirement annuity contracts written by life assurance companies and approved under the provisions of Finance Act 1956 section 22 and successor provisions had to have as their main object the provision of a life annuity for the contributor in old age. The Act gave effect, in part, to the recommendations of the Tucker Committee[1]. Evidence before the Committee favoured tax relief on contributions made to secure a deferred life annuity[2]. Most representations to the Committee suggested that the provisions should permit tax-free commutation of one quarter of total benefits[3]. Tucker recommended that relief should be available for contributions securing a specified amount of annuity at a specified future retirement age[4]. The report also proposed that limited tax-free commutation should be permitted. Insurance offices should be free of tax on the profits of the fund.

3. The commutation proposals were not carried into effect in the 1956 Act. But the basic requirement of the legislation was that the contract provided for an annuity. Approval of a retirement annuity contract provided by 'a person lawfully carrying on in the United Kingdom the business of granting annuities on human life' was competent so long as the contract did not:

> "(a) provide for the payment by that person during the life of the individual of any sum except sums payable by way of annuity to the individual; or
>
> (b) provide for the annuity payable to the individual to commence before he attains the age of sixty or after he attains the age of seventy; or
>
> (c) provide for the payment by that person of any other sums except sums payable by way of annuity to the individual's widow or widower and any sums which, in the event of no annuity becoming payable either to the individual or to a widow or widower, are payable to the individual's personal representatives by way of return of premiums, by way of reasonable interest on premiums or by way of bonuses out of profits; or
>
> (d) provide for the annuity, if any, payable to a widow or widower of the individual to be of a greater annual amount than that paid or payable to the individual; or
>
> (e) provide for the payment of any annuity otherwise than for the life of the annuitant;
>
> and that it does include provision securing that no annuity payable under it shall be capable in whole or in part of surrender, commutation or assignment."[5]

Section 22(3) provided for the discretionary relaxation of the strict requirements of sub-section (2) in circumstances that are not of central importance for present purposes.

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[1] Report of the Committee on the Taxation Treatment of Provisions for Retirement, February 1954 (Cmnd 9063) –the 'Tucker Report'.
[2] Tucker Report, paragraph 320.
[3] Tucker Report, paragraph 326.
[4] Tucker Report, paragraph 372.
[5] Finance Act 1956, section 22(2).

4. An annuity is, in essence, an annual payment of a sum of money, a defined income stream, for life or for a defined period. The Act did not adopt the language of Tucker and stipulate a 'specified' annuity. Contemporary evidence indicates that by 1959 there was widespread use of with-profits annuities, and more limited use of variable annuities such as index-linked or unit-linked annuities. There were also trust-based arrangements. It seems likely that the paradigm in 1956, in the case of an insurance contract, was a specified annuity. That did not exclude other forms. None of the provisions of the Act, in its original form or as amended, and no practice of the Inland Revenue, stipulated how insurance companies were to compute or quote for the provision of the annuities they sold.

5. The Inland Revenue had discretion to waive certain of the requirements of the Act, and concessionary practices developed that relaxed those requirements. For example, strictly, retirement annuity contracts required to be written as annuity contracts. But the Inland Revenue had no objection to policies written to provide a cash fund provided that at maturity the fund was paid as an annuity. It was expected that the contract would show a primary form of annuity benefit payable if none of the policy options was exercised. In relation to guarantees, the official internal instructions stated:

> "The contract may specify a guaranteed minimum annuity rate, but need not do so."

The nature and extent of the Inland Revenue's use of discretion were generally characterised as allowing some leeway in the strict interpretation and application of the legislation, making it clear where the Board of Inland Revenue could not depart from the law. The use of discretion was concentrated on the form of the benefits provided or the scope for making contributions.

6. The review carried out by the Inland Revenue for the inquiry did not uncover any papers indicating that the Inland Revenue had any influence over the creation or development of, or conditions attached to retirement annuity contracts that guaranteed annuity rates, expressly or implicitly. Despite repeated assertions in correspondence that the Inland Revenue did influence life offices in this respect, no evidence has been offered to the inquiry, or found by the Inland Revenue or the inquiry in reviewing the literature, to support this contention. Nor is it evident what reason they might have had to do so.

7. The Inland Revenue has, rightly in my view, hesitated to assert that there never was any statement that might have had some bearing on the use of guarantees in retirement annuity contracts. The inquiry related to events from 1956 onwards, and the most comprehensive review of extant records could not guarantee that nothing had been missed. But I am satisfied that, having regard to the scope of the legislation, and the record of contemporary practice referred to below, the contention that annuity guarantees were required by the Inland Revenue has no substance.

8. So far as Equitable is concerned, the problems that have arisen in relation to annuity guarantees are directly referable to the decisions of the Board and management of the Society from time to time to offer annuities incorporating guarantees that became progressively more costly. The selection of the implicit valuation factors, and the values attributed to them, were at all times a matter for the Society to determine in a competitive environment. They were not required by the legislative structure, nor influenced by Inland Revenue practice.

9. The advanced study group of the Insurance Institute of London began to study the industry's problems with the implementation of the 1956 Act in the autumn of 1956, and published its report[5] in 1959, reflecting the findings of the group at January 1959. The report contained valuable research data and findings on contemporary life industry practice. Generally, it appears that apart from elements

[5] Report of the Insurance Institute of London, No 140, 1959.

of policy and practice that were dictated by the language of the legislation, there was wide variation in the forms adopted by different offices. The report described the policy forms that had been devised by offices in the period of study. The contracts were, of necessity, deferred annuities on the life of the person claiming tax relief. The annuities were non-commutable and non-assignable. Subject to that it was found that all types of deferred annuity were available, with return or without return of premiums on death during deferment. With return contracts were issued with return of premiums either without interest or with interest. There were varying commencement dates, varying adjustments of rates according to age at commencement, varying guaranteed periods of payment, varying periods of payment and varying provisions for flexible premium contributions. The business was highly competitive, and even in 1959, the terms offered were attractive and appeared to allow little margin for possible improvement in mortality.

10. In respect of contributions, the group found that single premium contracts were common. Some offices made provision for the payment of occasional single premiums. It found that most single premium contracts carried no rate guarantee, i.e. the terms upon which any further annuities could be purchased by single premium would depend upon the rates of premium in force when the additional premium was paid. But practice varied, and in some cases rates were guaranteed for limited amounts, or for limited periods, or even without qualification. Equitable fell into the final category.

11. In respect of with-profits business, the group identified the sources of profit as being: (a) expenses; (b) interest; (c) investment returns; and (d) mortality. Observations on these factors reflect an objective assessment of the risks associated with retirement annuity business from an early date:

> "The loading for expenses involved in these contracts would appear to be small so that any contribution to profits from this source must also be small. In present investment conditions a source of profit probably exists under (b), but it must be remembered that retirement annuities are long-term contracts. It is no doubt expected that careful management will lead to a profit under (c). Whether (d) will result in profit or loss depends upon the future trends of mortality. Further improvement in mortality rates beyond that allowed for in the premium basis could result in loss to the life office and accordingly it is necessary for actuaries to take a cautious view of future trends when deciding premium bases for retirement annuities; if the actuary is over-cautious, however, a profit from mortality may result. Competition for this business is, however, fierce and exercises a restraining influence so far as possible profit margins are concerned."

One has a clear impression of a market place in which practitioners had, or, after publication of the report ought to have had, a full and proper appreciation of the areas of risk associated with writing retirement annuity business. However, the market was highly competitive, and the risks may not have been fully acknowledged in practice.

12. The sense of well-understood commercial risk was heightened as the report proceeded to analyse practice. There was implicit criticism of one of Equitable's practices:

> "In most cases the annuity only participates in profits during the term of deferment but this is not an invariable rule. At least one office allots a final bonus of an increased amount when the annuity commences as some compensation for the fact that the annuity then ceases to participate in profits. Annuitants who live longest tend to cause the office a loss and therefore it may seem anomalous that annuitants should continue to participate in profits after the vesting date; ..."

The report acknowledged the attraction to the policyholder.

13. The report analysed policy forms into standard clauses, reflecting the requirements of the legislation and Inland Revenue concessionary practice, and non-standard clauses developed by individual offices. The standard clauses did not include a requirement for a guaranteed annuity rate. In relation to annuity benefits, the Report stated:

> "It is in respect of the benefits provided that the greatest degree of variation was found among the policies studied by the Group. It can be said that no two offices use exactly the same approach to the drafting of this section of the policy..."

The group reported finding participating and non-participating deferred annuities. There were varying provisions for conversion to paid-up status. There were varying options available at maturity. There were varying death benefit provisions. A principal variation highlighted was between pure life annuities and life guaranteed for a period. Some offices wrote all policies to 'mature' at a fixed age. Some provided flexibility of varying degrees. Many offices showed tables of the annuities that would be secured at alternative ages, either as actual amounts or percentages of the scheduled rates. For present purposes, the lack of any comment on implicit or explicit guaranteed annuity rates is significant. The publication of tables of rates, which was assumed as a norm from which variations were identified, might imply an implicit conversion rate in possession. But it appears not to have attracted attention.

14. The range of policy types found by the group, in early 1959, demonstrates that there was not an Inland Revenue requirement for annuity guarantees, either as to duration or as to amount at maturity. Those were features within the discretion of the office, and reflected the competitive position the office sought to develop. Equitable's initial implicit guarantees were of low value, both in respect of guaranteed investment return and the implicit interest rate component of the conversion rate in possession. The Society increased the growth and conversion rates implied in its retirement annuity contracts in October 1975, and maintained the new rates for new contracts until June 1988, and thereafter as rate guarantees in continuing contracts written in and after October 1975. The highest levels of uplift in policy values in the compromise scheme submitted to members in the Autumn of 2001related to business written in and after October 1975. It was in relation to that business that the Society's annuity guarantee problems arose. The rate levels for earlier business were considerably lower, and the resulting problems less material. The reasons for increasing the rates in October 1975 were related to the Society's competitive position in the market[7].

15. In the 1950s and 1960s retirement annuity business was not a major component of the Society's total long-term insurance book. That was dominated by business written under the Federated Superannuation Scheme for Universities. Pensions business generally and retirement annuity business in particular became more significant at the end of the 1960s and into the 1970s. The improvement of the Society's competitive position in the pensions market in the mid-1970s, and the resulting guaranteed annuity rate problem in the 1990s, were wholly the product of management decisions as to the levels of guarantees and the marketing of the products. They were not dictated by legislative or other external factors. I shall deal with this aspect of matters when discussing the Society's pursuit of growth in the 1970s.

[7] In their representations in response to the maxwellisation process, two of the former executive directors, David Thomas and Roger Bowley, have said that in about 1975 there were low equity markets and very high gilt yields of around 16%. That might explain the use of high guaranteed rate components at that time for current business. It makes it more difficult to understand accepting a commitment to an unlimited premium guarantee for new business reflecting those rates, and especially difficult to understand why the Society persisted in writing new business reflecting those rates until 1988.

Premium Bases for Annuity Guarantee Products

16. At the time of the *Hyman* case and subsequently, officers of Equitable contended that the guaranteed annuity rates had not been charged for, that a charge was appropriate, and that it could be exacted from the terminal bonus otherwise payable at maturity, effectively retrospectively, if the policyholder required payment on the guaranteed basis. Alternatively it was envisaged that the cost of the guaranteed annuity rates could be charged against the funds attributable to policies with annuity guarantees generally, the basic ring-fenced solution. In this, as in many aspects of the issue, there are questions of terminology.

17. It appears likely that in their use of the expression 'guaranteed annuity rate', Equitable's officers had in mind the conversion rate in possession only; there was no discussion of the guaranteed investment roll-up rate also implicit in the annuity guarantees. If this is a valid inference, it implies that in some way the guaranteed investment roll-up rate was charged for: otherwise that also should have been the subject of a charge at maturity. Alternatively, it implies that a distinction was drawn in practice between two factors contributing to the annuity guarantees in the policies without any obvious logical basis. By the late 1990s the Society sold a number of products with no or zero roll-up rates of investment return: the treatment of the guaranteed investment return was not a theoretical issue.

18. Between 1962 (the first declaration of bonus after the introduction of retirement annuity contracts) and 1973 the Society declared the same reversionary bonus rate for all existing classes of major with-profits business. Minor with-profits contracts were dealt with in a different way. Corley[8] states that the terms for the retirement annuity contract were set so as to enable the same reversionary bonus rate to be used as for the then existing major classes of business. That was what happened in practice, and Corley's observation coincides with evidence I have received. From 1957 until the triennium ended 1973, retirement annuity maturities were awarded a form of final bonus. An earlier maturity bonus on endowment business had been discontinued in 1962. Until the end of the 1971-73 triennium there had been no other terminal bonus system in operation since 1962. The initial rating of the business could not have had regard to the terminal bonus element in the total benefits structure that was to come into effect in and after 31 December 1972 in terms of the 1973 declaration. The limited form of final bonus allotted to retirement annuity maturities was intended to align retirement annuity payments with the Society's current immediate annuity rates, which reflected anticipated profits over the term of the annuity.

19. Later assertions that it had 'always' been the intention of the Society to recover the cost of guarantees from terminal bonus cannot be true in any absolute sense. Such a policy could not have pre-dated the introduction of the general terminal bonus in 1973, by which stage the principal elements of the structure of the retirement annuity contract had been fixed. The introduction or application of the original final bonus, designed to increase the annuity yield on retirement annuity maturities, would have been inconsistent with an intention to reduce policy value in respect of the guarantees. It would have operated against the interests of the rest of the with-profits fund if it implied favourable differential treatment instead of achieving parity with those purchasing immediate annuities.

20. The inquiry has not recovered the premium books used in the 1950s. But the general information available indicates that there were implicit guarantees in with-profits business generally, dominated in 1957 by endowment and whole life business. The use of common reversionary bonus rates across the major with-profits fund until the triennium ended 1973 ignored the distinction in tax treatment between gross and net funds. A balance had been achieved to the satisfaction of the Society's actuaries that was not disturbed in practice until 1973. At that time the

[8] Report of the Corley Committee on Inquiry regarding the Equitable Life Assurance Society, Faculty & Institute of Actuaries, September 2001, Appendix 2 paragraph 3 (vi).

taxation differential was taken into account, and a higher reversionary bonus rate was declared thereafter on gross funds. There was no suggestion that the premium bases had become mutually inconsistent for any other reason.

21. Barry Sherlock, who was general manager and actuary of the Society from 1972 to 1991, and appointed actuary from the introduction of that office until 1982, told the inquiry that when his predecessor, Maurice Ogborn, introduced the retirement annuity contracts in 1956–57, he made the guaranteed terms marginally less favourable than those available on pre-existing policy classes to protect the existing classes from the possibility that holders of the new policies would take an unfair share of surplus. While it would be speculative to suggest a causal relationship in the absence of specific evidence of rates, the use of a final annuity adjustment would have been consistent with compensating for any unfairness arising from this difference in the light of experience down to maturity. Sherlock told the inquiry that the purpose of the final bonus was to correct potential unfairness of applying the guaranteed rate without adjustment to the current equivalent immediate annuity rates which were geared to current fixed interest returns.

22. The first edition of the Institute and Faculty of Actuaries' guidance note 1 (GN1) was issued with effect from 1 May 1975. It provided that the financial position of the office, on which the appointed actuary had a statutory duty to report, was particularly affected by:

(a) the premium rates on which existing business had been, and current new business was being, written, and

(b) the nature of the contracts in force and currently being sold, with particular reference to all guarantees

among other factors. Failure to apply the guidance in GN 1 was prima facie evidence of unprofessional conduct. It would require clear evidence to infer that despite the guidance Equitable was writing business after 1 May 1975 on premium bases that did not cover guaranteed liabilities without there being a report by Sherlock, as appointed actuary, that highlighted this deficiency. It appears on the information available to the inquiry that the Society's premium bases were loaded for profit in excess of the guarantees, in the case of retirement annuity business as with other major with-profits business.

23. The Society did charge explicitly for certain guarantees at the time the retirement annuity contract was introduced. The Society's standard contract for university teachers under the Federated Superannuation Scheme for Universities (FSSU) was written as an endowment policy, payable in cash or convertible into an annuity at current rates at maturity. The Society made available as an option a guaranteed conversion rate in substitution for the current immediate annuity rates. For that option a separate charge was made. It is clear that the benefit of that guarantee was not a characteristic of FSSU business generally, for which the standard premium bases might have made provision, but was and was seen to be an additional and optional benefit which the policyholder might elect to take, and for which there was a price. The Society might have adopted a similar approach to retirement annuity business, promising a level of annuity dependent on immediate rates at maturity with an optional guarantee for which there would have been payment. However it did not do so in the case of retirement annuity contracts, though it did adopt that approach in other pensions contracts as mentioned below. In the case of retirement annuity contracts, the policyholder paid a premium appropriate to the benefits secured by the policy, and the guarantees were explicit elements of those benefits.

Equitable's Guaranteed Annuity Rate Contract Forms

24. Equitable wrote policies containing annuity guarantees in a number of forms. At the reference date the Society had in issue four groups of such policies: retirement annuity contracts, individual pension contracts, group pension schemes and transfer plan contracts. The forms of the contracts varied, generally reflecting

differing statutory requirements for approval for taxation purposes. No new business with annuity guarantees was written after 30 June 1988, but in certain group schemes there were contractual rights to introduce new members to existing schemes that subsisted until 1993. Existing policyholders generally had the right to pay additional contributions without revision of the rates of benefit stipulated in the original contract.

25. The annuity guarantees fell broadly into two categories which can best be distinguished and illustrated by reference to examples. Most retirement annuity policies were written with the annuity as the primary benefit with an option to convert the benefit into a cash fund for application in the purchase of alternative benefits within a specified range. The individual pension and group pension schemes were written with a cash fund as the primary benefit for application in the purchase of specified benefits, underpinned by the annuity guarantee.

26. The earliest form of retirement annuity contract recovered was first issued in 1957. It provided for a premium-based guaranteed annuity, with-profits, expressed as follows:

> "[T]he Society will pay to the Grantee an annuity of the amount shown in the Schedule hereto (increased by such amounts if any as shall under the rules and regulations of the Society have been allotted by way of addition to or bonus thereon) or as may be agreed under Proviso 3 according to the age at which the annuity is to commence ..."

In structure, and in language, this policy conferred a contractual right to, and imposed on the Society an obligation of payment of, the guaranteed amount, as increased by such additions and bonuses as might be 'allotted' under the rules and regulations of the Society. The policy did not specify the form of allotment, or define restrictively a relevant class of allotments. The schedule set out a 'Table of Guaranteed Rates of Annuity', varying according to the age of the policyholder at the date of payment of the premium, payable on maturity at age 70. The annuity that the Society was obliged to pay in accordance with the Schedule reflected (a) a discount for expenses; (b) a guaranteed roll-up rate of interest; (c) a guaranteed interest rate in possession; and (d) a mortality factor appropriate to the maturity age selected. However, none of these computational elements was specified. Additions and bonuses increased the annuity directly, and were in the form of additional annuity payments.

27. The contract form provided options: (1) to pay further premiums on the same terms and conditions subject to Inland Revenue limits; (2) to take benefit earlier than the prescribed age; and (3) to take benefits in alternative forms, including a surviving spouse's annuity and an annuity for qualifying dependants, all subject to Inland Revenue limits. The option for early retirement did not provide explicitly for the adaptation of the contractual rates of annuity to rates payable at an earlier age. The grantee and the Society had to agree a specific sum for effective selection of a retirement age under 70. The mechanism envisaged was that the substituted rate would be agreed and inserted in the policy. The same approach applied to subsidiary annuities such as those for surviving spouses and dependants. As a matter of construction the options were dependent for effectiveness on agreement being struck at the material time. In practice on early voluntary retirement between 60 and 70 the annuity was determined arithmetically[9].

28. The interpretation of the policy document, in the light of the Society's articles of association, would have left much unsettled without reference to extraneous facts and circumstances. In the case of a single life, uncomplicated by renunciation and subordinate annuities, the policy promised a specific annuity rate per £100 of premiums, increased by additions and bonuses, if any. Bonuses would have accrued, if there were profits, to the date of maturity and no further. Leaving aside

[9] Corley Appendix 2, paragraph 3 (ii). The observation relates to the later 1975 form, but appears to reflect earlier practice.

mechanics, and assumptions based on the operation of the with-profits system generally, the policyholder was entitled to participate in profits to maturity. Article 65 provided for regular bonuses at valuation, and, in paragraph (2), provided for interim or additional or special bonuses between valuations. The smoothing of returns, by averaging to ensure steady distribution rather than making an immediate distribution of the returns of the current period, and the reserving of surpluses would have depended on views as to the scope of the directors' general discretionary powers in the determination of amounts available for distribution.

29. The form of contract was amended from time to time. For present purposes, only the most significant amendments need to be mentioned. Partial commutation of retirement annuities was permitted by the Finance Act 1971. The Society adopted a new form of retirement annuity contract incorporating a commutation option in that year. The commutation option was written as a proviso to the primary obligation to pay the annuity, which remained in the same terms. The proviso, in clause 6 of the policy form, was effective at the pension age selected by the policyholder, and was that:

> "the Grantee may elect ...:
>
> > (a) to be paid on attaining the selected age by way of commutation of part of the annuity payable to the Grantee hereunder a lump sum calculated in accordance with the Commutation Table endorsed hereon but not in any event exceeding three times the amount of the annuity remaining payable to the Grantee after such commutation"

30. The table of guaranteed rates of annuity was in structure the same as that in the 1957 form. The commutation table contained a note in these terms:

> "The amounts of annuity to be commuted shown in this table will be increased by a percentage equal to that by which the annuity is increased by any final bonus (which expression shall mean any amount which shall under the rules and regulations of the Society be allotted by way of addition to or bonus on the annuity at the selected age and which shall be described by the Society as a final bonus)."

31. Typically, the retirement annuity forms provided:

> "This Policy shall confer right ... to participation in the profits of the Society up to the date on which the Grantee attains the selected age and no longer."

As mentioned above, when bonus was first declared on retirement annuity policies at the 1961 quinquennial valuation, the Board adopted a policy of paying a final bonus on this class of business, on the advice of the Society's principal actuaries. In a report to the Board dated 22 March 1962, on the valuation, the actuaries stated:

> "This is the first occasion on which participating policies in the pension annuity fund will receive bonus additions... Since, ... these contracts participate in the profits of the Society up to the retirement of a member but no longer, there is the special problem of the profits that may subsequently emerge while the annuity is in course of payment. We recommend that compensation for the anticipated profits should be given by means of a final bonus, allotted at the time of retirement. This takes the form of a special interim bonus applicable to pension annuities..."

The advice is examined in more detail later in the context of the Society's bonus policy. For present purposes it is sufficient to note that it was recognised at this early stage that there had to be a unique adjustment to the guaranteed rates of annuity for which the policyholder had paid premiums to lift the annuity to current annuity rates.

32. The final annuity bonus was only available to the extent that the benefits were taken in annuity form. The provision in the 1971 commutation table was intended to ensure that the uplift was not reflected back into the commutation process, so

increasing the cash amount available. The uplift was available only as a supplement to the annuity. Subject to that, the 'annuity payable' reflected all additions and bonuses allotted to the policyholder. The final bonus, in particular, was described as a sum allotted under the rules and regulations of the Society with a specified description.

33. Section 26 Finance Act 1978 allowed an open market option to be provided in retirement annuity contracts, allowing the cash equivalent of pension benefits to be applied in purchase of an annuity from a different office. In May 1979 the Society adopted a radically different form of contract. The primary obligation of the Society was now expressed in these terms:

> "The Society hereby covenants with the Grantee that ...
>
> (a) if the Grantee shall survive to the Selected Pension Date the Society will pay to the Grantee the Annuity increased by Related Bonuses (if any) ... upon and subject to the terms and conditions set out in this Policy"

'The Annuity' was defined as 'the Annuity purchased by the premium specified in Endorsement 1 and calculated in the manner specified in the Sixth Schedule'. There was provision for the purchase of 'Further Annuities': subsequent premium payments purchased equivalent benefits The contract included an 'Illustration of Benefits' in endorsement 1. Paragraph 3.0 of the fourth schedule provided a commutation option in general terms, and subject to agreement, without arithmetical expression. The commutation table had been removed from the form.

34. 'Related bonuses' meant: 'in relation to the annuity such amounts (if any) as shall under the rules and regulations of the Society have been allotted by way of addition or bonus thereon.' The mechanics specified continued to envisage bonus annuity additions. The only limitation was that the amounts had been 'allotted' under the rules and regulations of the Society. As with the older forms, the provision did not apply exclusively to declared reversionary bonuses. By endorsement the Society imported the reference to 'related bonuses' into the older contract forms, where it had to include the special final bonus. One might criticise the drafting of the endorsement, but what is important is that the Society saw the use of the expression 'related bonuses' as appropriate in the older and new forms without differentiation.

35. The sixth schedule provided for the computation of the annuity in two stages: first, the determination of the accumulation value of the premiums applying table A, and thereafter the determination of the annuity by applying table B. There were provisions for determining a cash fund value by applying table B in reverse, effectively providing that the accumulation value of the residual annuity after the exercise of other options would be the measure of that sum. Paragraph 1.5 of the sixth schedule provided that:

> "Having ascertained the Accumulation Value at the Selected Pension Date of the premium paid in respect of the Annuity ... in accordance with the preceding paragraphs of this Schedule the amount of the Annuity ... shall be the amount of the annuity attributable to such Accumulation Value at the Selected Pension Age by reference to Table B."

The basic rights had not changed in character. The right conferred was a right to an annuity arrived at by using annuity rates. The mechanism had changed from the earlier forms, in respect that in response to the open market option there was specification of an intermediate stage in the calculation, but there remained only one measure of the annuity right.

36. It can be deduced arithmetically that in the 1979 form the implicit discount for expenses and the guaranteed investment return were reflected in the calculation of the accumulation value. The mortality factor and the interest rate in possession were reflected in the conversion rate set out in table B. By 1979 the Society's bonus

practice had developed to include terminal[16] bonus payments. The only mechanism by which such bonuses could affect the amount payable was by including them in 'related bonuses' so that they entered into the calculation of the annuity in terms of the sixth schedule. That remained the structure of the retirement annuity policy thereafter.

37. In the Society's group schemes, the table of retirement benefits expressed the benefits as cash sums assured. The proceeds payable at maturity had to be applied to purchase an annuity from the Society from among the classes of annuity then offered. In the 1979 form, which was typical, paragraph 1.2 of the fifth schedule provided:

> "Any annuity ... shall be purchased from the Society at the rates used by the Society at the date of purchase for an annuity of the same class provided that the Society guarantees that the rates used will be calculated on bases no less favourable (mutates mutandis) than those used to calculate the examples of rates set out in the Table of Examples of Guaranteed Annuity Rates contained in the Seventh Schedule. ..."

The examples covered retirement at 60, 65 and 70, and annuities on a level basis and increasing at 3% per annum, for single male and female lives and for a male life with a surviving widow's benefit at half rates. In this case, there was an example of a guaranteed conversion rate, in Corley's terminology. The basic contractual right was to an annuity at the current annuity rates appropriate for the class of benefit selected subject to a guaranteed minimum level of benefit. The contrast with the retirement annuity forms is clear. The Society was able to distinguish the benefits on offer for different classes of business, and had readily available forms to reflect such distinctions as were intended.

38. In further contrast to the retirement annuity forms, group pension policies provided for revision of terms for future contributions. The 1979 form achieved this by conferring a qualified option to pay further single premiums on the premium day, in order to secure proportionate benefits to those set out in the table of guaranteed rates of retirement benefit. The qualification on future payments was in these terms:

> "Provided that the Society may once in each of the successive periods of five years the first of which commences on a date four years from the Date of this Policy revise the rates contained in the said Table of Guaranteed Rates of Retirement Benefit upon such basis and in such manner as it shall in its absolute discretion think fit upon giving the Trustees three months notice of its intention so to do.."

excluding retrospective effect.

39. The variation provision would have allowed the Society to change its rates to accommodate changes in any of the actuarial assumptions implicit in the premium bases, once in every five-year period. The benefits structure was fund based, with the primary obligation of the Society to provide an annuity at current annuity rates subject to a guaranteed minimum level. Later forms of this type were to the same effect. Again it is to be noted that the Society had available clauses that could have been adapted to introduce similar limitations in the case of retirement annuity business if that had been desired. It was never done.

40. The Society's final salary policy adopted a different mechanism. The primary obligation of the Society under this form was to pay an annuity of the amount payable in accordance with the employer's pension scheme rules agreed with the Society in return for the contributions paid. The cost of the annuity was to be based on the Society's current annuity rates, subject to a guarantee that the cost would not exceed the amount brought out on an application of the guaranteed rates set out in the schedule. The mechanism was different from the AVC/group model, but the

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[16] Later subsumed into 'final' bonus.

effect was the same. The rates set out in the tables were variable at the instance of the Society once in every successive five-year period.

41. At the time retirement annuities were introduced, favourable tax treatment was already available for retirement benefits schemes promoted by employers which qualified for exception from the operation of section 386 Income Tax Act 1952 under which schedule E tax applied to the premiums. A common form of scheme was the 'top hat' variety meeting the requirements of section 388 of the 1952 Act.

42. The inquiry recovered an early form of Equitable contract of this type dated 30 January 1976. By then the relevant legislation was contained in section 323 Income and Corporation Taxes Act 1970 and Finance Act 1970 Part II Chapter II. The grantee of the policy, the beneficiary's employer, had an open-ended option to purchase further retirement benefits on the terms of the policy, subject to maintaining the conditions of eligibility for exemption. Benefits were expressed as a cash fund. The total retirement benefits, being the aggregate of the retirement benefits sums assured, and specified in the second schedule to the policy and later endorsements had to be applied in the payment of such cash benefit as was required under the rules or in securing an annuity or annuities with the Society or under the open market option. The sixth schedule provided tables of guaranteed rates of retirement benefit sums assured, depending on whether payment of the premium was before or after 1 June 1976, a table of guaranteed annuity rates applicable to the total retirement benefits, and a table of reductions for early retirement.

43. In July 1988 the Society wrote to group pension scheme clients intimating an intention to amend the contracts in respect of new members. The note stated, so far as is material:

> "Guaranteed annuity rates are withdrawn. The policy already offers an 'open market option' to the Trustees enabling them to buy pension from the most competitive source in the market place. The protection of the guaranteed annuity rate is no longer appropriate."

44. The letter and note were accompanied by a formal notice of change. In October 1988 the Society distributed the endorsements and other documents intended to give effect to the changes and advised administrators to amend their explanatory booklets, offering to provide inserts for the purpose. The Society's intentions were not fully realised: trustees resisted the attempted changes, insisting on the right to introduce new members to their schemes for a further five years. The reason offered for the changes may not have withstood scrutiny. Two of the group scheme forms in existence at the relevant date were issued after the open market option was introduced in 1978. The changes became fully effective in 1993.

45. The Society altered the form of its Finance Act 1970 individual pension plan documents in December 1987. The brochure published at that time no longer contained provision for guaranteed returns. The 'form of benefits' section was in these terms:

> "Although a particular form of benefits may have been in mind when the plan was set up, the form in which retirement benefits from The Equitable's plan are actually taken is not decided until the time comes. Then, based on the fund available, any combination of benefits may be chosen provided that Inland Revenue limits are not exceeded....
>
> Currently the Society offers a level pension, a pension whose value is related to the change in the Retail Prices index and a pension whose value is related to the profits of the Society..."

The annuity guarantee contained in the earlier form had been withdrawn.

46. The various policy forms differed in structure and language from each other. They also differed in effect, and gave rise to differing actuarial considerations. They differed to a greater extent from other with-profits business written from time to time that did not contain similar guarantees. It is impossible to avoid the view that the

Society's policy forms were carefully crafted to meet the perceived requirements of the relevant market sector targeted in each case.

47. With effect from 1 July 1988 the Finance (No 2) Act 1987 changed the taxation regime applicable to pension business. The Act ended the sale of new approvable retirement annuity contracts. From that date, existing contracts could remain fully in force, and additional contributions could be made within the terms applicable. Ongoing premiums continued to qualify for tax relief. New contracts had to meet the requirements introduced for the regulation of personal pension business. The new rules applied on transfer to a different office. If an individual with an existing retirement annuity contract wished to change his pension provider, he had to transfer into a personal pension scheme. In practice the Inland Revenue also permitted transfer to an occupational pension scheme by concession. Similarly, by concession, switching between funds was permitted without change of provider.

48. From July 1988 until July 1996 the Society sold personal pension policies with an express guaranteed investment return of 3.5% but without a guaranteed conversion rate in possession. The Society received legal advice from Dentons, the Society's solicitors, on a range of forms prepared at the time, following the introduction of the LAUTRO[11] rules, and the prescriptive code for disclosing product particulars. There was extensive correspondence relating to the Society's proposal to issue a composite form of booklet covering a range of related products of different classes. The solicitors were involved in detailed scrutiny and drafting of the Society's policy documents and booklets. They commented on ancillary issues, such as tax, when occasion demanded that. They considered the operation of with-profit clauses in many of the situations discussed. The inquiry has not uncovered evidence that their advice was sought on any risk of conflict between the interests of the new-type policyholders and the pre-existing retirement annuity class.

49. The Society published its personal pension plan policy booklet in July 1988. It provided for the identification of policy segments with separately defined rights. For a with-profits segment the provisions for calculation of the sum assured and related bonuses were:

> "(a) The Sum Assured secured by a With-Profits Segment shall be a variable sum equal at any particular date to 95.5% of the total of the premiums which have been attributed to such Segment each such premium having first been increased by compound interest at the rate of 3.5% per annum calculated from the date of payment of such premium to the said particular date with yearly rests.
>
> (b) Related Bonuses are also variable and will be calculated by the Actuary at any particular date in accordance with the rules and regulations of the Society."

Bonuses depended on the exercise of discretion. The basic guarantee was of an investment roll-up rate of 3½% on premiums discounted for expenses at 4½%. This form remained in use until July 1996 when the policy form was changed to exclude any guaranteed rate of investment return.

50. At the inquiry reference date of 31 August 2001 there were therefore in issue pension contracts (a) incorporating an implicit guaranteed roll-up investment rate of return, an implicit fixed expenses deduction, and a guaranteed conversion rate in possession comprising a fixed rate of interest and a pre-determined mortality factor; (b) incorporating an explicit guaranteed investment rate of return and an explicit expenses deduction; and (c) without guaranteed rates of any kind. In the remainder of this section discussion relates to the pensions business, with particular reference to retirement annuity contracts, since that was at the heart of the *Hyman* case and was thought to lie at the roots of the Society's difficulties at the reference date.

[11] Life Assurance & Unit Trust Regulatory Organisation, one of the self-regulating organisations recognised under Part I, chapter III of the Financial Services Act 1986.

However, there were guarantees in other classes of business, and contrasts within similar groups of business. For most of the relevant period, endowment assurances reflected implicit guarantees of investment return in the guaranteed sum assured. Premium scales were constructed by adding together a charge for the basic benefit and a loading for profit participation. In contrast, in 1990 the Society introduced recurrent single premium life contracts with no guaranteed growth at all. Most business of this kind was sold in the form of single premium bonds. The variety of contractual rights among policy types participating in the with-profits fund was considerable.

Evolution of a Differential Terminal Bonus Policy

51. Analysis of the Society's various retirement annuity policy forms shows that all bonus additions allotted to the policyholder required to be taken into account in arriving at the annuity payable. In some forms, particularly the later forms, options were based on accumulation values that excluded the value of the conversion rate in possession. But for the policyholder taking an annuity in terms of the contract, computation assumed that all allotted bonuses and other additions were taken into account in arriving at the annuity.

52. As discussed above, the Society adopted a policy of allotting a final bonus for retirement annuity business from the beginning. At the 1962 valuation when the policy was first implemented, the Society discontinued its previous practice of paying a maturity bonus on endowment policies and revised the basis of its reversionary policy declarations. Making particular provision for retirement annuity business distinguished it from other classes. The early practice was to be relied on in the late 1990s when the Society sought to defend the controversial differential final bonus policy that resulted in the *Hyman* case.

53. The joint reports of the actuaries and the course of discussions that followed the 1962 report indicated nothing that was particular to the retirement annuity form of contract and that engaged the interest or attention of the Board at this time other than the implications of the stipulation that the policyholder ceased to participate in profits when the policy matured[12]. The authority for the policy adopted was the absolute discretion of the directors in respect of distribution rather than any specific term of the contract. The directors had the comfort of the Society's solicitors' advice obtained at the time that their discretion was ample, subject only to moral obligations generated by policyholders' expectations in the light of earlier representations, and the possible qualification of their right to convert maturity bonus into reversionary bonus as an aspect of the revision of bonus practice in relation to endowment business. The approach to retirement annuity policyholders' rights was seen in this general context as primarily a matter of the directors' discretion absolute subject only to the obligation to act bona fide and for the benefit of the Society as a whole.

54. The inquiry has not uncovered any evidence that the directors sought legal advice on their powers in relation to bonus at any time thereafter until the Society was embroiled in the dispute that resulted in the *Hyman* case. For many years there was no practical financial issue for the directors. With the exception of a period in 1982 and 1983, none may have been anticipated throughout the period between 1957 and 1993. Current annuity rates were consistently higher than the implicit guarantees. New contract forms were adopted apparently without board involvement, as a matter of management discretion.

55. The first contractual reference to the practice of making a final bonus adjustment was in 1971, when the expression 'any final bonus allotted' appeared in the commutation table introduced in the light of Finance Act 1971 (see paragraph 29 ante). In the 1975 form the expression 'final annuity adjustment' was introduced

[12] Proviso 11.

into the statement of the Society's primary obligation. By that date the terminal bonus policy had been introduced. There was nothing inherent in the drafting of the provisions, nor in the records, to suggest that legal advice was taken on the implications of the changes of language. Similarly the substantial re-drafting of the form in May 1979 appears to have been carried through without significant concern about the wording.

56. When terminal bonus was introduced generally it coexisted with final annuity adjustment practice, with the change of terminology in 1975 differentiating the specific uplift from the general terminal bonus. That practice subsisted for a period. In the case of retirement annuity contracts, the Society allocated terminal bonus at a level rate (as was its practice in relation to major with-profits business generally at that stage) on a sum already increased by the final annuity adjustment, indicating that the benefits were cumulative in character. The final annuity adjustment was not a contribution towards or an element of terminal bonus. It cannot be accepted that it was 'always' the intention to recoup the 'cost' of the annuity guarantees from terminal bonus in any way associated with the original final bonus, or final annuity adjustment. The two elements were distinguished in terminology and in substance.

57. In the autumn of 1982 interest rates fell for a time below the interest rate in possession implicit in most retirement annuity contracts. The actuary noted the fall, and commented on the implications for bonus rates generally in a report to the board dated 24 November 1982. He advised that interest rates might remain at their current lower level, in which case the board needed a strategy that would enable bonuses to fall to the new lower level in an orderly fashion and at a pace that would seem acceptable to existing policyholders. If interest rates continued to decline the pace of reduction of bonus rates would need to be rather faster. If interest rates reverted to a higher range, current bonus rates would again be earned and the current fall would be seen to be a fluctuation downwards similar to the fluctuation upwards to very high interest rates in 1974. Those fluctuations were normally smoothed and not reflected directly in bonus rates. The actuary recommended that, in the light of the uncertainties about the future because of interest rates, it seemed appropriate in considering declared, interim and terminal bonus rates to avoid recommendations at either extreme.

58. There was concern over the implications of the annuity guarantees in relation to low interest rates that persisted into the New Year. The primary concern revealed was that there was a danger of large single premiums being paid at or before retirement to take the benefit of the annuity guarantee. With the GARs nearly in or in the money, it would have been open to a policyholder, subject to Revenue limits, to make substantial top-up contributions on guaranteed terms. Ranson proposed that a clause be designed to remove large single premiums from guaranteed terms.

59. An endorsement or additional term for new contracts was drafted by a member of the actuarial staff to meet Ranson's requirements in these terms:

> "The "Average Premium" from time to time is the annual average of retirement benefits premiums paid in the period, ending on the preceding policy anniversary, of ten years or the duration of the policy, whichever is the shorter.
>
> Where a premium is paid so that the total of premiums paid in the policy year exceeds twice the Average Premium the benefits secured by that excess will be based on annuity rates current at the date the benefits are taken and the annuity rates guaranteed in this policy shall not apply. Such excess premiums will not be included in the calculation of the Average premium in respect of future policy years."

The return on excess payments was to be limited to current annuity rates.

60. The specific risk arose because the contribution would have attracted the annuity guarantee directly, irrespective of any bonus allocated to the policy. The inquiry has not uncovered any other contemporary documentary evidence of

investigation or discussion of the implications for annuity guarantees at maturity in other circumstances. However, there is evidence that discussion did take place at least at executive level, and one indication of discussions by the board. In paragraph 3.2.11 of *With Profits Without Mystery*, the paper presented to the Institute of Actuaries by Ranson and Headdon on 20 March 1989[13], it was stated that the implications of reduced interest rate levels were discussed with the board after the fall in interest rates in the Autumn of 1982. In his evidence to the Treasury Select Committee, item 5, Headdon said that the board did look forward in the 1980s to an environment of much lower interest rates, and that: "The course of action that was determined to cope with that was to have a different final bonus rate to reflect the different value of the guarantees on the policy." He told the Treasury Select Committee that such different bonuses would be paid "consistent with the type of bonus approach that we have described to our members". In oral evidence to the inquiry Headdon confirmed that the intention to make compensatory adjustments to terminal bonus, that in due course came to be reflected in the differential terminal bonus policy, was discussed at about this time.

61. At a meeting of executives of the Society arranged to discuss the annuity guarantee issue in the autumn of 1998, Headdon gave a presentation on the background. He gave further information about the origins of the practice. He stated:

> "that internally the current argument (i.e. linking of guarantees) has been the consistent view for the last 15 years."

Fifteen years would have taken the discussion back to 1983 soon after the fall in interest rates in the autumn of 1982. The guaranteed annuity was briefly in the money at that time. Headdon's account has been consistent since, and is acceptable as reliable evidence. It is consistent with the manuscript notes referred to: specific provision for a situation that could not be dealt with by a differential final bonus scheme would be more likely to reflect a belief that the more usual contingency had been dealt with than that it had been overlooked. I consider that it has been established that a differential guaranteed annuity terminal bonus policy was conceived at the latest in 1983, and in a context in which discussion would have been appropriate. It would follow that it was understood when the change to personal pensions took place. The evidence supports the view that the Society's actuaries were conscious of the implications of a long-term fall in interest rates from 1982, or, at latest, early 1983, and that there would be implications for bonus, both reversionary and terminal. The precise form that the differentiation would take in case of need was not defined at that time, so far as the evidence has disclosed.

62. The inquiry has uncovered no evidence that the Board considered the interpretation of the contract documents at any time between 1982 and 1993, or had regard to the question whether the policyholders had legal rights that might bear on the scope of the directors' discretion in relation to bonus payments to retirement annuity policyholders generally or in the context of falling interest rates. Nor is it clear how far the views discussed by Headdon were communicated to staff.

63. The inquiry has recovered documents that appear difficult to reconcile with general knowledge of a settled policy of the kind suggested. The inquiry was given a letter dated January 1985 to a policyholder. The letter explained illustrations sent in response to a request for information. It said:

> "I have pleasure in enclosing some illustrations showing the benefits on survival to pension ages 60 and 65. The fund figure shown against basic benefits is the amount that is guaranteed under the policy. You will also note that existing declared bonus figures are shown and as these bonuses have been declared they are yours and cannot be removed again. In addition, you will note that a calculation for future bonuses has been made on the assumption that current bonus rates continue. Naturally, these bonuses have

[13] See chapter 4.

still to be earned. The total projected fund formed by these figures is then enlarged by a projection on the assumption that the existing level of terminal bonus will continue. The projected fund can be taken either as an annuity or as a tax free cash sum and a reduced annuity, and these figures are expressed under current immediate annuity rates - which means under present day conditions - or should interest rates be low at the time you take the benefits, then certain annuity rates are guaranteed in the policy to apply to ensure that you enjoy an attractive level of benefit."

64. In the form common at the period, the statement set out the basic benefits, existing declared bonuses, the additional bonus if current bonus rates continued up to the pension date, excluding any terminal bonus, to bring out the total projected fund excluding any terminal bonus. It then stated the total projected fund if, in addition, terminal bonus at the current rate applied at the pension date, and gave values for the alternative benefits payable on guaranteed rates and current annuity rates. The illustrations, read with the covering letter from which the quotation has been taken, gave no basis on which the policyholder could have identified an intention to recoup the cost of providing an annuity at guaranteed rates from what would otherwise have been the terminal bonus.

65. The evidence of the origins of the differential terminal bonus policy appears cogent enough. It is clear that communications with policyholders did not disclose that policy. It appears that the member of staff sending the letter to the policyholder last mentioned did not understand that there was a need to qualify the information by indicating that terminal bonus might be restricted should interest rates be low at maturity.

66. In 1986 the actuarial department carried out a retrospective analysis of the Society's premium basis rationale. It appeared that there had been a fall in market interest rates in March 1986. That had led to a review of current immediate annuity rates, having regard both to the interest component and to mortality assumptions. The paper did not suggest that there was any similar review of the retirement annuity guarantees even though the maximum affordable interest rate had fallen to a level at which the implicit conversion rate in the later (1975 onwards) retirement annuity policies was problematical.

67. There is some documentary evidence that the annuity guarantees were a focus of attention at the stage of preparation for and implementation of the change from retirement annuity contracts to personal pensions on and after 1 July 1988. The new form of contract included an explicit guarantee of an investment return of 3½%, but did not provide for a guaranteed conversion rate to be applied to the accumulated fund at maturity. As noted above the Society took steps to withdraw the guaranteed annuity rate from group schemes and AVC schemes for new members from 1988.

68. The change in policy form provided an opportunity for review of bonus policy, and may have dictated such a review. It would have been obvious that the creation of a new policy type, superseding so far as new business was concerned the entire retirement annuity class, required management, if not the board, at least to consider the inter-relationship of the old and new policy types, and whether there might be problems arising from including both in a single with-profits fund, especially if the differential terminal bonus policy had not already been anticipated. The differences in policyholders' contractual rights might have required an assessment of the relative positions of members of the new and old classes. It was at this stage that a new bonus class could have been created if that had been thought appropriate, either for the personal pension, or for all business other than retirement annuities, if that could have been agreed, or for some intermediate solution. In addition, there were wider economic considerations, such as the likelihood, at that time, that long-term interest rates would decline.

69. An outline specification for the new personal pension contract form, initialled by Ranson, in the PIT papers for 1 May 1987 set out the principal elements of the

new class of business. The intention was that all business would be written on a recurrent single premium basis, even if the formal arrangements were that a new contract was effected each year. Each premium would buy a fund at pension date (premium x 0.955 x (1.035)n: that is discounted by 4.5% for expenses and rolled up at 3.5% interest per annum). It was stated that no annuity rates would be guaranteed. It was envisaged, however, that the premium basis would be essentially as it was for 'section 226' contracts[14]. No record of discussion has been recovered. There was an indication in the PIT papers for 22 December 1987 that Ranson considered that pension fund business was not a matter for the team. But the item in the specification excluding guarantees was marked with a manuscript star. The decisions on guarantees and on the premium basis for the new business appear to have been taken by 1 May 1987.

70. Treating the premium bases for the two classes of business as equivalents is consistent with a pre-existing view, in the minds of the Society's actuaries at least, that a mechanism existed to ensure that policy proceeds at maturity in each case would be broadly the same notwithstanding the difference in defined policy benefits. By the end of the 1980s long-term interest rates were beginning to fall. One would expect that well-informed fund managers of life offices would have been aware of trends, and would have taken action in planning investment and distribution strategies to respond to them. The actions at the time support the view that a differential terminal bonus policy had already been developed as Headdon explained.

71. The Corley report suggested that the differential final bonus policy was devised in about 1988. That is inconsistent with the evidence reviewed by the inquiry. On either view, the paper *With Profits Without Mystery* is an important document, probably prepared in 1988 or in 1989, and instructive of the authors' thinking or lack of thinking about differential terminal bonus practice in the context of bonus 'philosophy' generally. It may reflect only the private views of the authors in a substantial sense. Corley reports that his inquiry team were "not aware of the extent to which this view was communicated to directors".

72. In paragraph 2.2.2 of *With Profits Without Mystery* the authors distinguished non-profit and with-profits business. At paragraph 3.1.3 it was stated: "We have not had to face up to inadequate premium bases (on interest grounds) for a generation. If those circumstances arose again, we should need to consider whether to allow the losses to emerge as they are incurred or to take the expected loss immediately." Paragraphs 3.2.12 and 13 show that by December 1986 the trend towards lower interest rates was firmly established in the authors' view. At paragraph 3.2.11 the authors stated: "The implications for bonus rates of the sharp fall in interest rates in the autumn of 1982, if the lower level had persisted for any length of time, were discussed with the board. Various plans were considered as to how to move to a lower bonus rate climate if that became necessary. Those early discussions, and reference back to them from time to time, subsequently eased the path in 1987 and 1988 when reduction] in declared rates were recommended." It is not clear how far the authors had in mind the differential terminal bonus policy at this time: that remained a mystery. But the comments were not inconsistent with a policy of that type.

73. An internal memo dated 23 October 1991 from the head of the business systems department to Matthews of APD (described subsequently within the Society as part of, or the result of a policy guarantees review) enclosed a revised 'Contract Guarantees' document with an amended section on the 'Circumstances in which the guarantees take effect'. This amended section said:

> "The guarantees could take effect in two circumstances;
>
> (i) if on death before benefits are taken, the full value of the fund reduced as if the life assured had retired on the date of death is less

[14] The description of the superseded retirement annuity form typically used the Taxes Act reference as shorthand. Section 226 of the 1970 Act was the current relevant provision.

than the value, at the date of death, of the guaranteed funds and declared bonus attaching to the policy.

(ii) when annuity benefits are taken

$$\text{Fund Value} \times \text{CAR} < \left[\begin{array}{l}\text{GCF purchased by all}\\ \text{premiums paid and}\\ \text{attaching DRB}\end{array}\right] \times \text{GAR}$$ ”[15]

This shows clearly that, by 1991 at least, the differential terminal bonus policy had been formalised within the business systems of the Society.

74. Some observations that have been made by commentators suggest that it was in December 1993 that the directors, confronted by the change in market interest rates in October 1993, adopted a novel approach to the calculation of terminal bonuses on annuity guarantee policies. In my view the evidence as a whole demonstrates that the policies underlying the actions taken at the end of 1993 and the beginning of 1994 were established internally by early 1983 at the latest.

75. These policy decisions were not made public. At least from the introduction of the open market option until December 1993, it appears that terminal bonuses on maturing retirement annuity policies were calculated on the same basis as for other with-profits pensions policies. One might have expected that after the differential terminal policy had been adopted, in any form, it should have affected policy illustrations prior to maturity for policies with annuity guarantee terms. It would have been material to policyholders and potential policyholders to have information about the risk that terminal, later final, bonus might be reduced if the contractual annuity guarantees were taken. Such information would have been material in the 1990s when policyholders had the options of entering into draw-down schemes, and staged retirement plans, and generally whenever the approach to calculation of lump sums under their policies was under consideration. The inquiry has not uncovered any example of a communication that did make the policy clear.

76. Paragraph 1.4.1 of the Baird report repeated uncritically Equitable's position that the 1990s practice reflected the Society's 'established' approach to distributing surpluses. There appears to have been no recorded reference at board level to a differential terminal or final bonus policy until 22 December 1993. This is a matter that has engaged not only this inquiry, but also the parties to the current litigation at the instance of the Society. At least so far as disclosed to the inquiry no party has uncovered any evidence that the policy was placed before the board in any way until December 1993. There were very full actuarial reports to the board, there were marketing reports and investment reports. At management level there were PIT minutes, and there were actuarial project team papers. Despite extensive search among the documents, the only material evidence recovered is as set out above in this chapter.

77. On 27 January and on 10 February 1993, the board considered actuarial reports on bonus. There was no reference to differential final bonus depending on the benefits selected. In November 1993, the board received the usual autumn actuarial report on bonus policy and principles looking forward to the next distribution. Headdon commented on the apparent high level of earnings; the impact of lower interest rates; the likelihood of capital gains being dissipated in future; and the strengthening of the balance sheet. He proposed that: “This year we can focus predominantly on fundamentals ...”. A differential terminal bonus was not mentioned.

78. In a manuscript memo to Ranson on 29 November, copied to Matthews, Headdon wrote:

“1. Following recent conversations I thought it would be helpful to summarise how I understand we are proceeding.

[15] 'GCF' refers to the guaranteed cash fund, and 'DRB' to declared reversionary bonuses.

2. Currently we are resisting pressure to pay total fund x GAR and are relying on the detailed wording of the formal statement of bonuses as a first line of defence. If we ran into difficulty you would be reasonably relaxed about paying total fund x GAR on the grounds that final bonus rates are marginally too low.

3. If we decide to increase final bonus rates w.e.f. 1.1.94 the approach will be:

(i) for contracts without GARs a rate of 12% for 1.1.93 - 1.1.94 and a rate of 10% from 1.1.94 onwards

(ii) for contracts with GARs a rate of 10% throughout from 1.1.93.

(The 2% margin broadly covers the difference between GARs and CARs at the moment.)

4. From 1.4.94 the final bonus rates will be described in a way which explicitly allows the cost of the GAR to be met from the final bonus. That is full fund x CAR will be paid unless (fund ex final bonus) x GAR is greater. Literature such as the Bonuses leaflet will make this approach clear.

5. One further thought since we spoke is that, if we are adjusting final bonus rates w.e.f. 1.1.94, we could move to an approach as in §4 immediately. That might draw less attention to the existence of the GARs than the approach in §3. The disadvantage is that presumably we will not be updating any literature in respect of a change to final bonus rates and so clients might feel that we had been a bit underhand in 'sneaking in' this change. Whatever we do, however, there is quite a fine balance to strike between being open and not drawing attention to the existence of the GARs.

6. Please could you confirm how you wish to proceed."

79. The issue of presentation of the Society's position was focused. However, Headdon's note disclosed that Ranson and he had in contemplation two options for recovering annuity guarantee costs from final bonus. The first envisaged differentiation in the rate allocated in the annual roll-up of policy values, the 2% margin referred to as covering the current difference between GARs and CARs. The second was the differential final bonus scheme that was implemented. The decision to deal with the issue wholly in terms of adjustment at maturity served to avoid drawing attention to the annuity guarantees as Headdon anticipated.

80. On 22 December 1993 the board passed a resolution in these terms:

"The Board approved the changes set out in the statement attached to the paper."

The paper on which the board had proceeded had proposed a range of changes in bonus rates in the light of experience to date, and stated:

"The attached amendment to the formal Statement of Bonus agreed at the 10 February 1993 Special Board makes that change..."

Among the detailed material was a new paragraph to be included in the notes to retirement annuity bonus notices relating to differential bonus policy: paragraph 7. The narrative of the report made no reference to this, and there was nothing in the record to suggest that particular attention was drawn to it. The note stated:

"Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate to the cash value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time the benefits are taken to the cash value of the benefits before such reduction."

81. In a television interview for Channel 4 News on 27 May 2002, Peter Martin stated that the 'solution' devised by the actuaries was presented to the board in December 1993 and approved. He told the inquiry:

> "In 1994, when the DTBP [differential terminal bonus policy] came up, I recall Alan Tritton asking whether we were 'OK on contract' (having been assured we had article 65 *vires*), and that Roy Ranson had said 'Yes'. Headdon wrote a very comprehensive document on bonus policy in November 1993 and it was most certainly discussed. The DTBP was not presented as a matter for major policy decision; rather it was presented as a routine matter. There was no excitement factor in it. Annuity rates were reported as falling, asset shares would become un-equal, and we had to take steps to ensure asset shares were being paid out and not exceeded, this is how we would do this. It was presented in a mechanistic way."

82. Tritton told the Inquiry that he does not recall any discussion in 1993 about what came to be called the differential terminal bonus policy. No documentary evidence has been recovered that supports Martin's account. Since I have not been able to obtain the oral evidence of many of the directors involved, I have not been able on the total evidence available to form any firm view on what the Board knew of the policy at this time. The report by Headdon of November 1993 which is available to the inquiry does not deal with differential terminal bonus rates. The report for the board meeting on 26 January 1994 making firm proposals for bonus did not deal with differential terminal bonus rates. The board resolved to reduce declared rates. Headdon's report commented on the need to strengthen reserves in the light of the sharp reduction in yields, and on the risks associated with a failure of interest rates to revive. The report was fairly full, fairly technical and appears to have contained nothing relevant to the annuity guarantees issue. The draft directors' report reflected the decisions, and noted that final bonus was not guaranteed and might be varied at any time before payment. It seems that this was the formula developed at the time to give notice that there might be variation of final bonus but without specification of any particular policy. In the light of the decisions taken, it would hardly qualify for plaudits for frankness.

83. After December, when the previous year's notes were altered, the issue was raised next in the formal valuation and bonus declaration for 1993 placed before the board on 9 February 1994. Note B7, the note quoted above as amended[16], reflected the differential final bonus policy. The statement was approved by the board. Note B9, dealing with reservation of the directors' right to reconsider final bonus rates at any time was specifically referred to in the minutes of the meeting: the board resolved to reserve the right. Note B7 was not specifically referred to. The issue was clearly before the Board. Martin's assessment of the matter as routine and mechanistic would reflect the treatment of the issue as recorded.

84. If it had been possible to accept Martin's statement that the actuaries' solution was approved by the board without qualification, that would have implied full complicity of the board (a) in adopting the policy, and (b) in authorising its application. The policy was not advertised in communications with policyholders. The actuary's letter to retirement annuity policyholders relating to the1993 bonus is referred to later in the wider context of bonus policy. There was a further marked shift from reversionary bonuses: (a) there was an absolute reduction of 1%; and (b) there was a larger relative shift towards unguaranteed final benefits. But there was a failure to make any comment on the decision that adverse current annuity rate conditions could be compensated for by differential final bonus allocations to policyholders who exercised annuity guarantee rights. The letter states:

> "In summary, therefore, we have substantially increased total policy values, but with a smaller increase in the guaranteed element than in recent years. We feel this is the proper response to events in 1993."

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[16] See paragraphs 94 and 96 below.

The "events in 1993" had included the first sustained fall in current annuity rates below the levels guaranteed.

85. In evidence to the Treasury Select Committee, Equitable stated that the decision to adopt a "differential final bonus practice" was taken at the end of 1993 on the advice of the appointed actuary. The board papers do not disclose this advice, only the note of the changed language. In a circular to policyholders dated 24 June 1999 Nash wrote:

> "Since market annuity rates first fell below the guaranteed annuity rates in 1993, the Society has calculated different final bonuses where benefits are taken in guaranteed annuity form."

This implied a consistent application of the differential terminal bonus policy from 1993 onwards, but it was neutral on the origins of the policy. In a wider context, on 30 November 1993 there was a meeting between Ranson and GAD. The note of that meeting included the following comment:

> "Pensions business has a guaranteed annuity rate at about 7% but this was not as onerous as it appeared since, because 'old' policies had been given the benefit of more modern features and options, it would be reasonable (in his view) for the allocation of final bonus to be conditional on the waiving of this guarantee."

If this note is accurate, (and it fails fully to reflect contemporary manuscript notes of the discussion at the meeting) a number of issues arise, for the Society and the regulator. It appears to express the issue in terms of waiver, and therefore of contractual rights not being enforced. 'Waiver' is a materially different concept from failing to exercise an option. But it reflects the view that full final bonus would not be available where the guarantee was not waived.

86. Meanwhile discussion of the alternative approaches continued within the Society's management. Soundy, an actuary in the APD[17], prepared a note for Ranson in which he noted two disadvantages to the differential terminal bonus policy. The first concerned integrity; the office was "effectively reneging on its guarantees". Clients, he noted, "will expect that the full value of the fund will be available at retirement to provide benefits. This is not consistent with having one fund value if GARs are used and another higher value if they are not." The longer that interest rates remained low, the greater was the likelihood that complaints would become serious. "The worst scenario is that we are forced to change our practice and to compensate those who have already taken benefits." The second disadvantage was that the amount of final bonus might not always be sufficient to cover the cost of the guarantee.

87. Soundy then went on to discuss the alternatives. The basic issue was who should bear the cost of the guarantees. He observed that the current approach meant that the cost was borne by those who chose to invoke the guarantees. The alternatives were the whole class of GAR policies or all with-profits pension policyholders. He assessed the impact of the alternative options in detail, dealing with the technical analysis of the cost of the options and the relative reputational implications..

88. The note was copied to Headdon on 13 January 1994, and he responded the following day. He commented that the

> "general exposition of the advantages and disadvantages of the current approach seems fair and to provide a good basis for discussion. I am, however, less happy with the financial analysis. There is also little discussion of the disadvantages of your alternatives."

Headdon thought Soundy had underestimated the impact on bonus rates needed to achieve 'self-financing' by the class and questioned the logic of the mathematical

[17] See chapter 1, paragraph 8.

approach adopted. More fundamentally, perhaps, he thought that the approach "pays lip service to fairness without looking through to the underlying position". He was concerned that the result would be that in 20 years the pension would be 15% lower than under the current approach, and 30% lower for clients who did not want to take the guaranteed annuity. "How do we cope with that?", he asked, "What are the implications for surveys of competitive results?" Headdon also said that he could see no reason for policies without a guarantee to join in subsidising those that did, though he accepted that where the final bonus was insufficient to cover the cost, the shortfall should be met by the business as a whole. On the other hand, he agreed that

> "... vigorously defending the current position and then changing it is highly undesirable. Accordingly, there is an urgent need to confirm our long-term approach to this issue."

He suggested a discussion with Ranson, to whom he copied his response.

89. Soundy responded on 17 January. He had looked further at the cost of honouring the GARs, and challenged some of Headdon's figures. He calculated that the business spread over at least the next 30, rather than 20, years, and that the approximate averaged cost (if interest rates remained permanently below 6%) was 1% p.a. But the uncertainty over the likely future costs highlighted a basic problem with funding the GARs in advance. There was no statistical basis to do so. Any reserve was bound to be too low or too high. If it were too high, the reserve would become surplus for the benefit of a future generation. Alternatively a later generation might need to make up a shortfall. In addition, it was "not consistent with what we have done (or not done) in the past". Instead he proposed

> "... that the most sensible course is to charge for the GARs on a 'pay as you go' basis. That means that in any year the reduction in bonus rates for the class is calculated to be sufficient to cover the likely cost of honouring GARs for maturities in that year only."

He discussed the treatment of annual deficits or surpluses and the possible need for "some form of short term smoothing". But in terms of fairness,

> "I believe that this may be the best way forward and is 'fair'. The philosophy is that all GAR type policyholders have joined the 'GAR club'. By doing so, all have implicitly agreed to bear some cost, if necessary, for the benefit. When GARs bite, all then existing GAR policyholders subsidise the maturities then taking place."

90. This memo clearly raised ideas that would subsequently have a bearing on the resolution of the issue in the Hyman litigation, most particularly the notion that the GAR policyholders had implicitly agreed to bear the cost of the guarantees. Soundy ended his memo by offering to arrange a meeting with Ranson. He told the inquiry that he remembered a meeting taking place with Ranson and Headdon, but could not recall what transpired. Soundy commented in his statement to the inquiry that:

> "It was hard for me to have a significant influence in that discussion as they had all the financial information needed, and I was also junior to them."

The 'pay as you go' approach was not adopted.

91. At the meeting of the Board on 23 February 1994 there was no recorded discussion of differential terminal bonus. The position was the same at the March and April meetings. The board set up an audit committee in 1994. The committee met on 14 March. The subject matter of the meeting was the 1993 accounts. This minute contained nothing of significance on the annuity guarantee issue. There were references to pensions mis-selling, which was described as 'the only major judgmental area'.

92. Yet it must have been about this time that the decision was taken not to inform policyholders of the differential terminal bonus policy, if that was done. It is

stated in the Corley report[18] that the Society's board "confirmed a 'differential final bonus practice' to equalise the benefits in GAR and cash form", and that some policyholders who retired in the winter of 1993-4 may actually have been credited with a reduced terminal bonus. It is also stated[19] that the directors were preparing to communicate the policy of selective reduction in terminal bonus in the spring of 1994 when the market changed again. Corley paragraph 64 says:

> "We understand that the Equitable was preparing a communication explaining the policy of selectively reducing the terminal bonus to go out with the bonus notices in the spring of 1994. When market annuity rates rose above the GAR again, the Equitable decided not to issue the communication."

The inquiry has not recovered minutes of any meeting that covered the developments mentioned by the Corley report. The timing of the suggested discussions coincides generally with the preparation of the actuary's annual 'dear policyholder' letter, which would have provided an appropriate context for intimation of the differential terminal bonus policy. But it is clear that the communications with policyholders at the time did not disclose the policy.

93. The format of the customary actuary's letter accompanying the bonus notice remained broadly similar to the previous year's, concentrating on the Society's general bonus policy, economic conditions, and the amount of overall return. In terms of detail the letter was considerably less explicit than the previous year's. There was no table analysing the application of the overall return, for example. Critically there was no reference to the treatment of annuity guarantee policyholders who had elected to take the guaranteed rate over the winter of 1993-94.

94. In the notes distributed with the retirement annuity policyholders' annual statement of bonus for 1992, note 2 stated:

> "The final bonus addition reflects current investment conditions and is not guaranteed. It can be expected to vary in the future."

For 1993, the note, issued in February 1994, was developed to read:

> "The total fund values include amounts of final bonus which are not guaranteed and may vary up or down. The fund available at retirement on or after 1 April 1994 may therefore be less than the total value shown, but would not be less than the guaranteed value."

95. By February 1994 the decision on differential terminal bonus had been taken in respect of the final quarter of 1993 and for 1994. The variations, omitting reference to current investment conditions, and the express reference to the final sum being less than the value shown, must reflect the decision on terminal bonus, and it would be understandable if there had been an intention to circulate members to provide more information.

96. The Society's formal Statement of Bonuses approved in special meeting in February 1994 contained at B7 the form of note agreed in December with a related note dealing with the cancelling out of the benefit of guaranteed interest rates and other additions in certain circumstances:

> "Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1993, or such later date of purchase of benefit as applies, to the date of payment of benefits, the amount of final bonus allotted... is reduced by the amount of any such increase.
>
> Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by

[18] Corley, page 13, paragraphs 62-63.
[19] Corley, page 14, paragraph 64.

applying the appropriate guaranteed annuity rate to the cash fund value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time benefits are taken to the cash fund value of the benefits before such reduction."

The Society's retirement annuity policies did not provide a guarantee of "minimum rates for annuity purchase..." The policies were drafted in terms of a guaranteed rate of annuity for a given premium. Some group pensions business and AVC plans did contain provisions that could be described in such terms. But the expression was not accurate as a generality.

97. The form adopted for the 1995 declaration was:

"The total fund values include amounts of final bonus which are not guaranteed and may vary. In addition, where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee. The fund available at retirement may therefore be less than the total shown, but would not be less than the guaranteed value."

Again, the retirement annuity cannot be described as providing terms on which annuity benefits could be secured.

98. The 'dear policyholder' letter did not disclose the policy or the reasons for its adoption. The bonus notices issued to policyholders did not reflect the terms of the differential final bonus in 1994 or 1995. It was to be in 1996, with the bonus notices for the 1995 declaration, that there was direct disclosure to policyholders of the nature of the adjustment.

99. In March 1997, the results for 1996 were intimated. Again the 'dear policyholder' letter was silent on the issue of the differential final bonus policy. The notes to the annual statement of benefits provided:

"The non-guaranteed final bonus addition is the difference between the total value and the guaranteed value. The total values include amounts of final bonus which are not guaranteed and may vary. In addition, where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee."

The surrounding presentation had changed, but the relevant language remained the same.

100. The notes issued in 1998 for the 1997 declaration, appended to the annual statements issued in the spring of 1998, did not mention the differential terminal bonus policy at all. But, by the end of the year policy illustration material explicitly described the policy in action. For 1997 the note stated:

"The non-guaranteed final bonus is the difference between the total value and the guaranteed value. The amount of final bonus payable is not guaranteed and may vary. The actual amount payable will be determined when benefits are taken."

101. It appeared that the issue began to make an impact during 1997. The first complaints to PIA Ombudsman were intimated in July 1998.

102. In the 1998 declaration it stated:

"Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1998, or if later the date of application of the individual purchase, to the date of payment of benefits, the amount of final bonus calculated ... is reduced by the amount of any such increase.

If the contract guarantees minimum rates for annuity purchase the aggregate final bonus otherwise applicable is reduced when benefits are taken by the

amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate after such reduction, is equal to the annuity which would be secured by applying the Society's annuity rate for an equivalent annuity in force at the time benefits are taken to the cash fund value of the benefits before that reduction, subject to a minimum value for the final bonus after such reduction of zero.

If the contract guarantees minimum rates for annuity purchase and a reduction has been made under the immediately preceding paragraph, then were benefits are not taken in a form to which those minimum rates apply an additional amount of final bonus will be made available to the policyholder at the time benefits are taken equal to the reduction if any made under the immediately preceding paragraph. Such additional amount of non guaranteed final bonus will not constitute a "related bonus" or bonus allotted under the contract."

103. The bonus notice was adapted again. The note stated:

"This policy contains guaranteed rates of annuity which apply to with-profits benefits secured by contributions paid. At retirement, such benefits under the policy may be taken in guaranteed annuity form, or the total value of the benefits available, if taken in fund form, may be used to purchase an annuity from the Society on current rates or may be taken under the open market option to purchase an annuity from another provider.

The value of benefits in guaranteed form will never be less than the total value of the with-profits fund available at retirement and, depending upon financial conditions, may exceed that total value. That is because the annuity payable will be at least as high as that produced by applying the Society's current annuity rates to the total value. ...

The non-guaranteed final bonus is the sum which the Society would need to allocate to the policy by way of addition to the guaranteed value to produce the total value of the benefits available if taken in fund form and used to purchase an annuity on current rates. The actual amount of any final bonus will be the sum which the Society would need to add to the guaranteed value at retirement in the financial conditions prevailing at that time in order to produce the then actual total value. If the policyholder takes benefits in guaranteed annuity form, and if guaranteed annuity rates are higher than current annuity rates, the amount which would be needed to be added by way of non-guaranteed final bonus in order to bring the value of the benefits under the policy up to the stated total value will be less than that required if current rates were applied, and could be nil.

The actual amount of any final bonus is entirely a matter for the Board of he Society in the exercise of its discretion and it not guaranteed under the policy..."

The Board had taken legal advice from the Society's solicitors and counsel in respect of this year and that was reflected in the new formulation[20].

104. The varying terminology used in communications with policyholders over the period from early 1994 to early 1999 in relation to the differential final bonus policy is perplexing. On any view the policy went to the heart of the Society's business. From the board papers, it would appear that the issue was not clearly focused in formal reports or in recorded discussion until 1998, and then only when counsel became involved. For the board meeting on 28 January 1998 Headdon prepared a paper on bonus. In the principal paper and its appendix he proposed that apart from adjustment to rates, 'all other terms, conditions and rules' for final bonus should be the same as at 12 February 1997. There was nothing of note. Thereafter nothing significant occurred until counsel's advice re-interpreted the Society's past

[20] See chapter 1.

practice and led to the significantly reformulated notes incorporated into the declaration and notices for 1998 published in 1999. The board appear to have had no relevant information until the briefing meeting on 9 September 1998 to deal with adverse publicity.

Maintaining a single with-profits fund

105. Another significant issue thrown up by the annuity guarantee issue and, in particular, the failure of the ring-fencing proposal arose from the Society's consistent practice of publishing financial information with reference to a single undifferentiated with-profits fund. The issue was dealt with in the joint opinion by Warren and Lowe dated 10 May 2001. They explored ways in which it might be suggested that the Society could have established separate funds. The advice stated:

> "[We] have no doubt that it would have been possible to create a separate fund out of the contributions of the new non-GAR policyholders and for the rights of participators in that fund to be defined in such a way that the profits derived from that fund could be dealt with, so far as concerned terminal bonus, in such a way to give effect to the bonus policy actually adopted by the Society once the annuity which could be purchased with a given sum of money applying the current annuity rate ("CAR") fell below the annuity which could be purchased with that sum applying the GAR. It is absolutely clear that the Society did not do this. .."

106. However, the mechanics would have required the creation of a separate fund for the new with-profits business pursuant to Recital (F) and Article 57 of the Society's Memorandum and Articles of Association. Recital (F) provided for the creation or setting aside of a special fund or funds and for the giving to any class of policyholder or annuitant special rights over the fund so created. That power could only be exercised, by virtue of Article 57, with the sanction of a Special Resolution of the Society. As Mr Warren and Mr Lowe observed, the Society did not take that course. Indeed it appears that the possibility was never raised. The focus of the Society's attention was different: far from contemplating a segregation of with-profits funds, the unity of the fund was emphasised in published statements, with a view to marketing advantage. The notional hypothecation of the fund into sub-funds circumvented the provisions of the articles by treating the matter as a management issue.

107. On 24 June 1987 Ranson presented a paper to the Board on the new personal pension, then expected to be introduced from 4 January 1988. The paper did not identify features of existing business that would be departed from. It stated, however:

> " A strategy document was formulated by the end of March and agreed by the senior management team. A major component of the strategy was to make use of existing products, as much as possible, in order to minimise the changes needed to existing administrative and computer systems, and to enable the Society to exhibit an unbroken track record of past performance."

108. The new form of business was to be aligned with the superseded retirement annuity contract to ensure that previous performance records could be used with reference to the new contract. This explanation has been consistently offered by the management. The brief prepared for TSC hearing in 2001 said:

> "It was very important for the Society at the time to maintain continuity of past performance. That necessarily meant that a separate bonus series could not be produced for PPPs, since it would no longer have been able to be possible to use the past performance for the GAR policies when explaining the benefits of the new policies."

109. Whatever the theoretical possibilities, formal segregation of funds at 1 July 1988 was not considered. It appears clear that had management expressly

considered the issue, it would not have thought it to be necessary: the decision to recover the cost of adverse annuity guarantee experience from terminal bonus would have provided a solution to the risk of falling interest rates, and no other remedy would have been thought to be required.

Conclusion

110. On the evidence available to the inquiry, the differential terminal bonus policy was the established policy of management from about 1982 or 83. The inquiry has uncovered no evidence to indicate that the policy was widely advertised to staff until about 1998. Similarly, apart from the general comment in *With Profits Without Mystery;* there has been no evidence that the board were informed of the policy before December 1993. The policy was first implemented in 1993-4.

111. It also seems clear that the critical decision not to split the with-profits fund at the point that personal pensions were introduced was taken (whether explicitly or not) on the basis that the Society intended to market the new policies as a simple development of the existing policies, relying on the investment record and returns to policyholders of the existing fund, and minimising the administrative burden for the Society. Management at least had recognised the potential value of the annuity guarantees within the existing policies, and are likely to have relied, implicitly, on the differential terminal bonus policy in making that recommendation. But there is no record that the inquiry has found to suggest that this was an explicit consideration so far as the Board was concerned.

112. It would be consistent with the inquiry's general findings on corporate governance that in the contexts of valuation of liabilities, product design, and the computation of policy benefits, executive management exercised a wide discretion unconstrained by active board supervision. It is this that enables the inquiry to conclude that the differential final bonus policy was developed in 1982-3, and influenced matters such as the treatment of personal pensions after 1 July 1988, the amendment of group and AVC contract forms, leaving retirement annuity contracts unaltered, the application of level premium bases to apparently incompatible classes of business, for example, without the Board of the Society being actively involved in the development of the policy and its implications for business generally. It appears unlikely that most members of the Board knew of the differential terminal bonus policy or its implications until the autumn of 1998, or that those who knew anything of the policy understood that it could have serious implications for the Society.

113. The House of Lords' decision in *Hyman* heralded the final phase in the Society's life as an office carrying on an active long-term business. Why that should have been the case requires a close examination of the Society's financial position over a long period of time. Superficially claims of £1.5 billion should not have brought down a Society with funds of £32 billion. A movement in liabilities of about 5%, though a significant injury, perhaps, should not have rendered the Society moribund.

PART II: THE SOCIETY'S APPROACH TO BONUS ALLOCATION

CHAPTER 3: GROWTH AND BONUS POLICY UP TO 1988

1. For the purposes of this report, interest in the bonus policies of the Equitable Board, and the Society's approach to growth, begins in the early 1970s. Up to that time, Equitable was a small, conservative, with-profits life office. The Society had two principal offices. The London office concentrated on investment and general administration. The Aylesbury office was the centre of actuarial administration. The Society was heavily dependent on business generated by the Federated Superannuation Scheme for Universities. By the end of the 1960s FSSU business accounted for some 50 to 60% of the total major with-profits book. At the end of the 1970s, when the scheme was in its terminal phase, income from FSSU sources still accounted for about 40% of the Society's aggregate premium income.

2. The Society came late to equity investment, but during the 1960s it began to enjoy the benefit of capital appreciation as equity markets grew in value. The Board initially adopted a very conservative approach to including capital appreciation in the computation of distributable surplus. Small amounts were appropriated in 1961, 1964, 1967 and 1970 in pursuance of a policy that limited appropriation to 10% per annum of the available amount. By the end of 1972, when Maurice Ogborn retired, the Society had off-balance sheet reserves of capital appreciation of £52m on a fund value of £143m. Maintaining ample reserves to provide full security for the office's obligations was established Board policy.

3. Doubt about the sustainability of FSSU business had existed from early in the 1960s: the scheme operated on the basis of tax and other concessions that could not be sustained indefinitely. Under the Finance Acts 1970 and 1971 there were changes in the general pensions tax regime that heralded the end of the existing arrangements. The FSSU had to be restructured, subject to a transitional period of ten years. In anticipation of this development, Equitable embarked on a programme of branch expansion in the middle 1960s, revised its marketing policy and adopted a more aggressive approach to sales.

4. Initially aimed at replacing FSSU business, sustained growth became an independent objective pursued with something approaching missionary zeal and with the conviction that the Society had a unique range of products and offered a unique level of service to its target clientele of high value policyholders. The pursuit of growth came to characterise marketing policy from the mid 1960s until the late 1990s. The growth achieved was associated with investment in additional resources. In 1963 the Society carried out a programme of branch expansion throughout the UK and increased its sales force. The Society increased and broadened its market penetration dramatically as a result. 80% growth in new premium income was achieved in 1963. By way of contrast no new branches were opened in 1965, when there were disappointing levels of new business. An independent review of the sales force carried out between 1970 and 1972 led to changes that resulted in a boost in sales at that time. These changes in administrative structure coincided broadly with the wider changes in the Society's business.

5. Before the 1970s, in-force pensions business had comprised mainly group pension and 'top-hat' schemes. Retirement annuity contracts for individuals were relatively insignificant in the scheme of business at the time. Until the mid-1970s the Society's total share of the pensions market was small. In 1974, when total premium income was £23m, the Society's 250 pension schemes (of all kinds) produced some £2m of annual premium income. In responding to the threat of gradual diminution, and ultimately loss, of FSSU business and promoting a campaign of sustained growth, the Society also changed its approach to the classes of business sought. Pensions business was a natural target, with the focus on high-value clients.

6. In its publications during that period, the Society presented the image of a progressive, dynamic organisation committed to the principle of mutuality, and to growth, economy and efficiency of operations for the benefit of its policyholders. The information and representations communicated to policyholders in particular and to the public generally about the Society's financial affairs were directed to the support of that image. The Society's published accounts and regulatory returns over time represented the consistent view that the Society had achieved growth, in terms of fund value and of business generally, and was committed to further expansion.

7. The Society's accounts reflected the success of that policy. The fund grew in value from £39m in 1960 to £34 billion in 2000. There had been average annual growth in asset value of 19% over the forty years corresponding broadly to the inquiry's period of interest. Sustaining growth at the rates achieved over that period required a highly trained and motivated sales force, efficiency and economy of management, attractive products and high quality client servicing. Equitable developed and sustained these characteristics over time. But fundamental to its growth was its competitive position in terms of returns to policyholders. Achieving competitive returns required sustained distributable surplus and a high level of bonus allotment.

Table 3.1: the Society's balance sheet, 1960-2000

Balance Sheet Extract	1960 £m	1970 £m	1980 £m	1990 £m	2000 £m
Total Investments	39	114	523	5,759	33,779
Net Current Assets	-	[1]	11	27	120
Subordinated liabilities	-	-	-	-	(346)
Net assets	**39**	**113**	**534**	**5,786**	**33,553**
Technical Provisions	39	113	534	5,576	31,242
Investment Reserve/Fund for future appropriations	-	-	-	210	2,311
Total fund value	**39**	**113**	**534**	**5,786**	**33,553**

The Pursuit of Growth

8. The idea that the Society regarded growth as an end in itself is one that would be resisted by its former management. John Sclater made the following statement in his presidential report to members for 1997:

> "Growth for growth's sake is not an aim of the Society; providing first-class benefits to our policyholders is - and our growth assists in that endeavour."

In his evidence to the inquiry, the former chief executive Roy Ranson, has denied that the management aimed for growth: for him growth was a by-product of the Society's approach to business, not an objective. However, while I can accept that the pursuit of growth was not the sole motive of management and the Board, an analysis of the Society's published financial information over time, and in particular many of the comments made by successive presidents in their annual statements to members of the Society, suggest that a view that growth was not regarded as an aim in itself is a somewhat romantic view of Equitable's approach to business.

9. Illustrations of the degree of commitment to growth appear throughout the Society's publications. A selection will be sufficient for present purposes. In 1975 the president reported that the Society's immediate aim was to replace the declining FSSU business with business generated through the branch organisation. The advance achieved in new business included a substantial increase in retirement annuity business. The Society was said then to be one of the leading offices in the field. In 1976, the president reported that the Society continued to develop its "compact, highly trained team of representatives" to support a planned programme

of controlled expansion. There was more extended discussion of that topic in 1977. In the accounts for 1978, the Society stated its corporate objective to be:

> "To provide life assurance and related facilities to as many people as is consistent with a high standard of product, service and advice."

10. In his presidential statement to members in 1980, David Murison altered the emphasis, and presented the growth in the field force as a response to increased demand for the Society's services. That remained the tone throughout his presidency. However, Professor Roland Smith returned to positive presentation of marketing objectives in 1986. He expressed the "guiding intent" of the Society as:

> "To achieve growth in the Society's business, being the provision of life assurance, retirement benefits and complementary investment facilities, by offering, without payment of commission, an appropriate range of products and services of consistently good quality."

11. The pursuit of growth continued to be a policy objective throughout Professor Smith's presidency. In 1988, he commented on the growth targets the Society had pursued and on the success achieved in exceeding those targets, and looked forward to pursuing further growth in 1989. Targets were abandoned in 1989: a fresh approach had been adopted that would provide a greater incentive and challenge to staff to produce growth. In 1992 Smith commented:

> "A mutual society such as The Equitable is a self-financing organisation and by encouraging more policyholders to join, in other words by growing, bigger benefits can be brought to the larger group and unit costs driven down still further. The carrying of The Equitable concept into Europe begins to build the Society for further growth by the turn of the century and beyond."

When he succeeded Smith, Sclater took up the same theme:

> "We are convinced that we should maintain our original mission, which is to provide benefits at cost to our members on a self-financing basis. By attracting more members we can do this more cost-effectively, to the advantage of both existing and new members."

12. However, to understand properly the attitude of the Society's management to growth, it is necessary to consider the influence that marketing had in the decisions taken in relation to bonus distribution. This will be explored in the remainder of this chapter.

Development of bonus policy in the 1970s

The 1971 - 1973 Triennium

13. The period of significant interest for the purposes of this report began with the triennium 1971 to 1973. Ogborn's successor, Barry Sherlock and his deputy Roy Ranson, obtained Board approval of a revised policy for the appropriation of capital appreciation in 1973. The bonus system they had inherited comprised (a) reversionary bonuses declared triennially and intimated to policyholders as contractually guaranteed increments to policy values; and (b) interim bonuses paid on claims between valuations, including in the case of retirement annuity policies a final bonus adjustment. In developing their advice to the Board in 1973, the Society's actuaries proposed, and the Board adopted the introduction of, a terminal bonus across all classes of with-profits business. The final annuity bonus adjustment continued as a matter of contract for a period, but was subsumed into the general terminal bonus.

14. Described as the 'three-call system', the new capital appropriation policy supported revenue surplus in three ways:

> (i) Between periodical valuations interim bonuses would reflect the income that could have been earned if the fund had been wholly invested in fixed

interest securities at the outset, unless the investment policy had been unsuccessful and looked like continuing to be so.

(ii) At the valuation date a first call on any capital appreciation that had accrued would be the amount required to make good any deficiency of actual income compared with the benchmark.

(iii) Since it was anticipated that there would be continuing deficiencies until the growth in revenue from equities and properties brought total returns from those sources up to the fixed interest rates available in the market, sufficient capital appreciation would be held in reserve to ensure an income flow equal to the projected deficiency estimated for the investment in question. That would be the second call on capital appreciation.

(iv) Any surplus appreciation would be available for allocation at the valuation date as terminal bonus or earmarked for future terminal bonus or for retention as free reserves. That would be the third call. Because market conditions could vary, a balanced and sensible approach would be to average the surplus appreciation over a period of time.

15. The policy was adopted, but immediately frustrated by adverse equity market conditions in the later months of 1973. Of the accrued capital appreciation of £52.1m at 31 December 1972, £21.5m was lost by the end of 1973. The balance was insufficient to operate the three-call system. On the recommendations of the actuaries, the Board applied £12m of the remaining capital appreciation as a first call, meeting the cost of interim and final bonus payments already made in excess of available revenue, and resolved to hold the balance of £18.6m as available for 'vesting bonus'. In the result the prudent second call reserve for future reversionary bonus was abandoned, and the available balance was held for terminal bonus. A terminal bonus rate of 10% was approved. If fully reserved that would have required the appropriation of £12m, but the Board was advised that the actual expenditure over the following triennium was expected to be £1m. It was to become a recurring theme of actuarial advice that terminal bonus was relatively cheap to service because the rate adopted did not impact on reserving requirements.

16. 1973 was a significant year in marketing. The Society's new business committee had developed a tentative five-year business expansion plan to replace the expected drop in FSSU business over that period. Declared bonus was the criterion used in marketing surveys at that time. Declared reversionary rates were increased. Sherlock later reported to the Board that if bonus had had to be reduced the effect on new business at a critical time would have been catastrophic.

The 1974 – 1976 Triennium

17. During the triennium 1974 to 1976 the Society pursued policies aimed at planned expansion. The pensions market, which had previously been a low-key operation, was targeted in particular. Until the mid-1970s, the Society's total share of the pensions market was small (see paragraph 5 above). 1974 was the first full year of the business expansion plan discussed in 1973. A new five-year plan was presented to the Board on 28 August 1974. It expanded on the proposals for new business development to substitute for the anticipated loss of FSSU business. But it also set aims for positive expansion rather than mere replacement of the loss of business.

18. Sherlock recruited Ken Wills as marketing manager. Wills introduced a 'commission' based remuneration scheme for sales staff, superseding a limited incentive scheme that had been introduced in 1970 by Ogborn. On 25 September 1974, a new performance-related bonus system for the sales force was recommended. Under Wills' leadership there was improved recruitment, training and management of the sales force. Considerable growth was achieved over the triennium. The long-term business fund stood at £172m at 1 January 1974. At 31 December 1976 it had a value of £242m.

19. The achievement of growth was celebrated in the president's statements to members. In his 1975 statement the president noted that new annual premium income transacted through the branch organisation was 79% higher in 1975 than in 1974. He intimated an intention to take further steps to advertise the Society, its competitive policies and the personal service offered to policyholders. Press advertising and favourable comment had attracted business. The approach in 1976 was similar. In his 1976 report to members, the president, now John Caldecott, commented on the Society's continuing growth:

> "No organisation can expect to operate unaffected by the influences around it; yet this Society has progressed at a pace, which bears no relation to the economic difficulties of the country. The new business transacted in 1976 was a record for the Society with new annual premium income showing an increase of 74%, and single premiums plus annuity considerations up by 226% against increases of 18% and 83% respectively for the industry as a whole."

New business from the original universities scheme declined by about 30% in 1976, but the total premium income attributable to it had not started to fall by this time. The Society's plan to replace universities business by business generated through its branch organisations had to date been outstandingly successful in crude terms. The financial position of the Society over the triennium as shown in its Companies Act accounts is summarised in table 3.2.

Table 3.2: abridged balance sheet for the 1974-76 triennium

	1974 £m	**1975 £m**	**1976 £m**
Investments	153.1	210.4	238.9
Current assets	2.9	4.1	5.3
Total assets	156.0	214.5	244.2
Current liabilities	1.6	1.9	2.4
Net assets	**154.4**	**212.6**	**241.8**
Long-term business fund	**154.4**	**212.6**	**241.8**
Off balance sheet reserves:			
- Opening position	18.6	0.9	2.6
- Movement	(17.7)	1.7	(0.5)
- Capital appreciation treated as surplus	-	-	(0.0)
- **Closing position**	**0.9**	**2.6**	**2.1**

20. The published accounts showed sustained growth in key balance sheet items. But the Society's capital position was not maintained. The off balance sheet position showed deterioration year on year. As at 31 December 1976, in addition to any inner reserves in liabilities, the Society had £2m in reserves of unrealised capital appreciation, which represented a solvency ratio of 0.9% (1973: 11%). At the end of 1974 this ratio was 0.6% and rose to 1.2% in 1975 before falling back to the final value[1]. Maintaining interim bonuses in 1974 had almost exhausted the off balance sheet investment reserve even after the change in liability valuation referred to below. The business barely broke even over the remainder of the triennium.

21. The 1973 valuation was said to have brought home to the Board a "growing and uncomfortable dependence upon capital appreciation" for support of bonus policy at reasonably competitive levels. On 22 May 1974, the Board considered a proposition that, in the changed investment conditions of the time, there was too great a risk in the Society's investment policy. The investment committee was asked to make proposals to increase the yield on the fund from 6½% in 1973 to 8¾% in

[1] See financial tables, table C.2.

1976 with a view to closing the income gap that was developing and reducing the anticipated income shortfall over the triennium by £10m.

22. 1974 proved to be a difficult year for the Society, in common with all financial institutions, with market values of quoted investments and properties falling almost continually. At 31 December, the market value of the Society's equity investments had fallen below book value. Total off-balance sheet capital appreciation on all investments had fallen from over £18m to under £1m. There was a dramatic recovery before publication of the 1974 accounts in 1975. But the Board decided that it would be prudent to make full provision for the unrealised diminution in the value of the assets at 31 December 1974. Equity investments were written down by £37m. There was no capital appreciation available to support interim bonus going forward in terms of the three-call system.

23. The pursuit of growth during 1974 presented difficulties. The current bonus rate required an investment return of 10½%. Maintaining that rate in the conditions of 1974 implied a revenue shortfall of £20m over the triennium. Current interest rates were expected to be 12% over the triennium. The bonus on that benchmark would result in a revenue shortfall of £30m and that was thought to involve risk[2]. Sherlock observed that if a rate of 7% (which the Society's financial position indicated) were applied in calculating premium rates, and bonus rates for illustration, new policies would be "unsaleable" in the current financial and economic climate. He commented on bonus policy at some length, identifying the "concepts" that provided a framework for bonus policy:

(i) The major part of the surplus should be distributed by way of the traditional reversionary bonus system.

(ii) A terminal bonus might be used to pass on to members leaving the fund any additional profits made by successful investments in equities and properties. These profits would be averaged out over time.

He advised the Board that the Society's valuation bases were deliberately stringent because 'general reserves' were necessary for the security of the office. There were similar comments on prospects in a report on investment strategy was presented on 25 September 1974.

24. In the circumstances, maintaining interim bonuses in 1974 and 1975 was clearly challenging. The techniques adopted in 1974 were to set a precedent for 1990 and 1994 when financial conditions were again difficult, and are important for that reason. Sherlock told that Board that in the valuation of major profits endowment assurances and deferred annuities the future bonus reserved for was slightly greater than the premiums would support. Some of the reserves set up were greater than the premiums and interest already received. He proposed reducing the rate of future bonus reserved, releasing £9m of surplus, but emphasised the importance of restoring the strength of the Society when conditions permitted. He went on to say:

"9. A further way to increase the surplus is to increase the rate of interest used in valuing liabilities and a number of offices are adopting this course at the present time, but only, I believe, as a means of releasing what might be called 'reserves'. If the fund has to be written down to market value with a consequential increase in the yield on the fund, then a higher rate is justified. In other circumstances it means taking credit for future increases in income.

10. A fall in the bonus rate must result if premium scales and bonus rates assume an investment return which is not in the event realized. It is too early to decide whether the long-term expectations on which ordinary shares and property were bought have proved wrong and hence we do not know to what extent we have really lost money. If we were declaring a bonus at the end of this year and conditions were unchanged I would not want members receiving benefits in the near future to suffer nor would I feel it right to vary the

[2] Set out in the paper of May 1974.

> expectations of our members generally. If conditions remain as they are for a further 2½ years, such a view might then seem optimistic."

He recommended a compromise solution that required altering the basis of valuation of liabilities, to release £9m of hidden reserves, placing all new money in gilts, and making minor but significant changes in the existing investment portfolio. His report was approved.

25. In the September investment report referred to above, there were comments on investment decisions already made, and their impact on yield. The report referred to the release of £9m of valuation margins, and continued:

> "7. However, the investment programme already settled will give rise not only to increased income but also to a higher yield on the fund at the end of the triennium provided that it can be and is carried through successfully. If this higher yield could be reflected in the valuation basis for the liabilities, the cost of the minimum bonus requirement ... would be reduced and further investment changes might not be so vital."

The report stressed that the Society would be financially less strong than in the recent past, and that strength could only be restored by improvements in investment position. At the date of the report the market value of investments was about £25m below balance sheet values. Sherlock recognised that if this continued to be the case at the end of the year "but more particularly at the end of the triennium", the simple picture he had painted would be more complicated. The first step would be to write down the fund to or below market value. In consequence yield on the written down value would increase. A higher rate could be used in valuing liabilities.

26. On 18 December 1974, Sherlock advised that interim and terminal bonus rates for 1975 should remain at 1974 levels, subject to revision when the year's figures had been finalised. On 22 January 1975, Ranson recorded that the Society had "mildly increased its share of the pensions market" (about 0.04%). An internal valuation report was presented on 26 March 1975. The Board resolved to maintain unaltered the current rates of interim and terminal bonus.

27. If the same basis as had been applied to the 1973 valuation had been used, the Society could not have funded bonuses at the pre-existing interim rates. It was said that an alternative 'realistic' valuation had demonstrated that the Society could maintain rates. There were two reasons for the lack of surplus on the previous basis: new business strain on certain classes of business, and the excess of projected bonuses on major profits endowment assurances over available earnings. The 'realistic' valuation depended on two assumptions: an interest basis of 10%, brought about by relating the revenue yield to the written down value of the Society's assets, and the reduction of future bonuses on endowment assurance, the major class of business at the time. The surplus brought out on the alternative basis was £7m. The cost of bonuses was £6.5m.

28. Writing down the investments in 1974 increased the running yield on the fund and enabled the actuaries to increase the valuation discount rate used in calculating the values of liabilities. The liabilities were reduced in value, and surplus was released. The technique was to set a precedent for 1990 and 1994 when again the Society faced adverse financial results.

29. In a later report, Sherlock commented that it had been recognised by the Board that the application of the principles on which the 1974 valuation was based would, if market values fell further, mean that the bonus might have had to be reduced and that the effect on new business at a critical time would have been catastrophic. He explained to the inquiry that the market's reaction to the oil crisis of 1974-75 was expected to be of short duration. New policies were sold on projected bonuses based on current bonus rates. If a bonus had not been declared, Equitable would not have been able to show projected benefits and the work of the sales force would have been made impossible. The decisions on interim bonus levels for 1974

and 1975 involved serious risk. The discussion during 1974 provides an insight into the decision to write down the value of the Society's investments at 31 December 1974, increasing the yield on the fund and reducing liabilities, that differed somewhat from the president's report to members, which, while acknowledging the losses incurred, was generally optimistic about the Society's prospects.

30. The need to maintain interim bonus at the rates previously announced for marketing purposes continued throughout 1975. The actuaries advised the Board that the course proposed involved risk (see paragraph 23 above). However, Sherlock pointed out that if rates reflecting the Society's current experience were applied in calculating premiums and in bonus illustrations new policies would be "unsaleable" in the current financial and economic climate.

31. In the event, 1975 saw a strong market recovery and a high return on investments. The £37m write-down from 1974 was reversed, generating apparent abnormal growth in capital value. On 17 December 1975, the Board decided to maintain interim bonuses for 1976 at the December 1974 levels. In October 1975 the Society increased the implicit roll-up rate of investment return on new retirement annuity and other pensions business from 3% to 3½%, and the interest component in the conversion rate in possession in annuity guarantees to 7%. Terminal bonus was set at 1.3%[3]. The guarantees in retirement annuity business, previously relatively insignificant, were potentially more onerous from this time onwards. The change was made when the Society was still in a weak position.

32. Papers presented to the Board on 23 June 1976 set out the debate on bonus in anticipation of the declaration for the triennium. The Society's experience during the triennium was discussed. Mortality was said to be a minor item. Experience had shown that mortality was likely to be consistent with the assumptions made. By the middle of 1976 expenses were becoming an increasing problem. The premium bases for 'private' (that is non-FSSU) contracts had made no allowance for the initial cost of writing the business. The expansion achieved since 1970 had been at a cost that could no longer be ignored. The excess of market value of investments over book value at 1973 had been lost and it could not prudently be expected that it would be restored by the end of the triennium. The surplus earned during the triennium would be inadequate to support bonuses at the current level.

33. In his paper, Ranson returned to the scope for releasing surplus by varying the valuation bases The valuation basis used at recent valuations for with-profit business had recognised and provided for significant new business strain: there was a cushion of 'hidden' reserves, which could be used (but only once) to meet adverse experience. Ranson's paper gave a clear indication of the implications of his proposal. He advised that the proposal would release reserves that had been deliberately built up over the years and would represent a weakening of the Society. He observed that reserves were essential to provide a cushion against adverse experience and to permit flexibility of investment policy. If the reserves were used, there would be no further cushion to meet future adverse experience whether related to mortality, expense or investment, and investment flexibility might be restricted. But the alternative was to cut the bonus rates, and that, he said, would be unfair to members whose policies were approaching maturity. His recommendation was that two-thirds of the reserves expected to be released by changes in the valuation bases (estimated to be £11m) should be added to the surplus from operations and treated as available for distribution. A further third would be released for the third year of the triennium. Overall, rates should be maintained. Sherlock's paper confirmed the loss of the Society's reserves as compared with 1972.

34. There were further comments on bonus looking forward in a review paper presented to the Board by Sherlock on 22 September 1976. He emphasised the relationship between new business growth and past bonus record. He said:

[3]See financial tables, table D.2.

> "Merely maintaining our bonus levels in 1977 will throw a strain upon the field force in the face of competitors who may be improving their scales, but we will still be capable of progressing. A reduction in the bonus rate in 1980, however, would undoubtedly have the most severe effect on our business-producing capability."

He reported projections on a range of assumptions for the triennium 1977 to 1979. Ignoring capital appreciation, there would be a shortfall in the surplus required to support bonus for the triennium. The yield projected was just over 11%, "a little below the rate needed to support the present scales of reversionary and terminal bonus, making allowance for operating expenses at their current level." He stated that it would be possible to recast the liabilities valuation basis to bring it into line with the yield being achieved and the bonus rate being earned. The effect would be marginal and insufficient to eliminate the shortfall. He said that it was not possible to plan for all contingencies, and an element of risk had to be accepted. There was little prospect of significant restoration of 'hidden' reserves.

35. Further preliminary reports on the 1976 valuation were presented on 23 February 1977 by both actuaries. The critical recommendation from Sherlock, with reference to Ranson's report, was:

> "3. The report shows, as forecast last year, that the surplus actually "earned" in the triennium was about 60% of the cost of the new bonuses assumed in the report and recommended below. The balance is available from reserves previously held within the reserve for policy liabilities. In my view, it is appropriate for the "hidden" reserves to be included in the surplus shown by the valuation.
>
> 4. It is for the directors to decide how much of the surplus disclosed by the Actuary's valuation can be regarded as distributable as bonus. If the directors expected the shortfall in "earned" surplus to continue indefinitely (after making due allowance for any capital appreciation which could be brought into account), they might feel it right to make a reduction in the bonus rate on this occasion. However, the policy of the Board has been directed to confirm the view which was held during 1976 that the whole of the surplus revealed by the valuation including the hidden reserves should be regarded as distributable as bonus. In my view as Actuary this would be a justifiable conclusion to reach and I recommend, therefore, that bonuses be declared at the same rates as in 1973."

He recommended that interim bonus rates be maintained for 1977. Terminal bonus should be paid at the existing rate of 10%. Ranson's report reviewed recent valuations, taking a somewhat revisionist approach to history. He informed the Board that in 1973: "an amount was earmarked for making up future shortfalls and the balance used to pay terminal bonuses on outgoing contracts", a comment that was inconsistent with his report for the Board of 28 February 1974.

36. Ranson recommended that the unrealised capital surplus, then estimated at £5m on a book value of £240m, should not be taken into credit because it would make the Society look "intolerably weak". He again contrasted the valuation with previous years when 'hidden' reserves were set up. The 'hidden' reserves of £12m had been stripped out. He said that general reserves would be held in an explicit form for the future. The valuation was explained. In relation to mortality it was stated that an allowance had been made in valuing private annuities to allow for increased longevity. Provisions for future bonuses had been selected to avoid 'hidden' reserves. The balance of the fund had changed. Pension business was one third of the total fund, particularly due to the removal of FSSU business that had been transferred to USS. Sherlock provided a formal valuation report for approval on 23 March 1977. The report was approved. In his statement to the inquiry, Sherlock speculated that the Board would have undergone a degree of soul searching to arrive at a decision, and that the directors must have considered that the current market situation was short-term. There is no documentary evidence that provides objective

support for this view, apart from the impression built up by the series of reports over the triennium reflecting the risks associated with the approach recommended. But there was a level of confidence that markets would recover, given that quoted companies retained substantial property and other capital assets at this period that underpinned their market capitalisation, and that happened in the short term. The non-executive directors included experienced investment specialists who would have been aware of likely market trends. And policies adopted for the remainder of the decade showed a desire to restore the Society's strength.

37. This was a period when the Society, which had actively pursued growth of new business, published its "corporate objective" in which the pursuit of growth was implicit, and experienced considerable levels of new business. It was said to be necessary for products to be very competitive. The Society's marketing methods, using high calibre salesmen, were said to demand a level of new business from each that was far beyond the norm in the industry as a whole. The required level was only possible if the Society's policies were manifestly attractive to the public, most particularly when assessed on the basis of past bonus record. Continued planned expansion of business was recommended. A pattern was set that became central to the Society's policy and the conduct of business. But at this stage the pursuit of growth and the preservation of capital strength were not treated as incompatible objectives. Although it resolved on a course that weakened the capital base, the Board's objective was to maintain adequate reserves. However, in the short term the pursuit of growth was sustained at a considerable price.

38. By 1976, the Board had used almost the whole of the Society's inherited unrealised capital appreciation and the hidden reserves in liabilities to maintain competitive levels of declared and interim bonus at a time of market volatility. It had done so without applying the prudent reserving policy that it had accepted in 1973. Despite the severe market conditions prevailing throughout the triennium reversionary bonus rates were maintained at 1973 levels of 5¼% and 6½% for taxed and gross business respectively. Investments generated income of an annual average of 8%, a sum of £48m, over the triennium. After capital depreciation, there was an annual average net investment return over the triennium of 5.7%. Total returns to policyholders, comprising typically the roll-up rate of investment return of 3½%, the declared rate of bonus of 6½% and the terminal bonus of 1.3%, required surplus of 11.3% (10% guaranteed benefits). There was an overall annual shortfall of 5.6%. The Board resolved to augment the surplus actually earned, essentially to meet the cost of the declared reversionary bonus, by releasing hidden reserves contained in the Society's liabilities. The main changes in the valuation were:

- To increase the valuation rate of interest, reducing the value of the liabilities as a result and releasing provisions to profit and loss account. This was justified on the basis that the actual yield on the fund was higher than forecast.
- To create a general reserve of £6m for higher levels of expenses than those allowed for in the calculation of the policy reserves, taking up some of the release.

39. The Society was left in a weak financial position. As presented in the Companies Act accounts there was total profit available for distribution of £28m, all of which was distributed as declared reversionary bonus. The total surplus (as reflected in the regulatory return), after providing for the guaranteed roll-up rate of investment return but before terminal bonuses of £3m paid during the triennium, was £30m. An undistributed balance of £1m had been brought forward, and £1m was carried forward. 98% of the surplus was distributed. The reserves at the end of the triennium had fallen to £2m on an investment base that had increased from £172m to £242m. The off-balance sheet investment reserves had been practically exhausted. The approach taken by the Board to strip out the reserves contained in the liabilities valuation left the Society vulnerable at year-end. The valuation and distribution policy adopted was designed to maintain the declared bonus rate to

continue to attract new business, despite market conditions placing the bonus structure under strain. No reserves remained to meet future income shortfalls by way of the second call concept.

40. This placed heavy reliance on the future performance of equity markets. That involved risk, because the Society was lean and had little or no room to manoeuvre. The position was aggravated by the failure to make any provision for terminal bonuses expected to be paid during the following triennium on maturing policies, an essential element in the Society's marketing strategy. The protective cushion of capital appreciation of £52m (representing 36% of fund value) that had existed at the end of 1972 had been lost. The Society did not have the resources to make any provision.

<u>The 1977 – 1979 Triennium</u>

41. Growth of business continued through the following triennium, 1977 to 1979, with conspicuous success. In 1977 the Society began a fresh programme of expansion. Significant growth was achieved in sales of individual pension contracts, boosted by a reduction in tax rates and increased personal savings. Marketing considerations lay at the root of the distribution policies pursued at this time. Maintaining competitive position in terms of bonus record drove distribution policy, and through it, the reserving methods and assumptions adopted. Surplus was a function of bonus policy rather than a value determining the limits of bonus policy. In 1978 there was an increase of 82% in total new annual premium income, which compared to an industry increase of some 30%. This was achieved without a commensurate increase in sales costs, thus enabling the Society to maintain a low sales cost to new premium income ratio. 1979 was "the end of an era" due to the loss of the FSSU business. The president reported that a far higher proportion of university teachers had transferred to the new self-administered pension scheme than had been anticipated. However:

> "At the same time the planned expansion of the Society has taken place but with greater results than were, or indeed could have been, foreseen. The marketing organisation is, as planned, roughly twice the size it was five years ago, giving better geographic coverage of the country and therefore better personal service to our policyholders. Both in the marketing organisation and throughout the Society, much attention has been paid to training so that business growth has been matched with high quality advice, service, and administration. As a result of a more positive marketing approach, the Society is better known than it was and is used very much more by professional advisers.
>
> The Society has emerged from the last decade well poised for the challenges and opportunities of the next."

42. The published financial position over the triennium as set out in the Companies Act accounts is summarised in table 3.3 (see over). The long-term business fund grew from £242m to £430m. Investment experience was initially good, but fell off over the triennium. The Society ended the triennium with investments at book value of £421m. There were investment gains of £61m in 1977 and thereafter losses of £2.5m in 1978 and £12m in 1979. The investments, at the end of this triennium, had a disclosed market value of £454m. Accordingly, as at 31 December 1979, in addition to any inner reserves in liabilities the Society had £33m in off balance sheet reserves in the form of unrealised capital appreciation, which represented a solvency ratio of 8% (1976: 0.9%). However, the level of cover had decreased progressively over the triennium. At the end of 1977 the ratio was 22%. It decreased to 18% in 1978 before falling to 8% in 1979[4]. The high level of capital appreciation achieved in 1977 was eroded by two years of depreciation.

[4] See financial tables, table C.2.

Table 3.3: abridged balance sheet for the 1977-79 triennium

	1977 £m	1978 £m	1979 £m
Investments	270.4	328.9	420.7
Current assets	10.0	11.7	14.7
Total assets	280.4	340.6	435.4
Current liabilities	3.6	5.8	5.6
Net assets	**276.8**	**334.8**	**429.8**
Long-term business fund	**276.8**	**334.8**	**429.8**
Off balance sheet reserves:			
- Opening position	2.1	62.6	60.1
- Movement	60.5	(2.5)	(11.8)
- Capital appreciation treated as surplus	-	-	(15.0)
- Closing position	**62.6**	**60.1**	**33.3**

43. Bonus policy remained central to achieving the Society's marketing objectives. In January 1977 Sherlock commented on the relationship between the two factors. At the same time, he acknowledged the Board's unease that the plan of action recommended on 22 September 1976 did not itself contain the means of closing the gap between earnings and distribution completely. (This was the clearest documentary evidence of the Board's unease at the distribution policies that had been pursued during the previous triennium.) He recommended investment policies aimed at increasing the revenue yield on the fund.

44. On 25 October 1978, Ranson submitted a paper on the treatment of unrealised capital appreciation. He rehearsed the three-call system and illustrated how it might apply at the 1979 valuation. The returns from fixed interest securities were taken as a yardstick for declared bonus. He stated that the method had not been applied at the 1976 valuation because, due to the market conditions then current, no appreciation was available. Market values had recovered and there would be appreciation to bring into account at the 1979 valuation. On the projected values illustrated, he expected that the system could be applied at the declaration. It emerged that he had departed from benchmarking against current market interest rates in adopting the reference rate for interim bonus in order to avoid a sharply higher level of declared bonus for the triennium that would have threatened the terminal bonus and might have led to a reduction three years later. Despite the principled approach rehearsed in the report, pragmatism had prevailed over principle.

45. The expectations of the market were a material factor. It is significant, in the light of what was to happen, that he said that the withdrawal of terminal bonus would be incompatible with the expectations of policyholders based on the Society's statements of practice, and on the assumption of smoothing. A further significant factor was the emphasis on setting bonuses at "desired" levels. It was a further indication of the Society's practice of setting bonus levels to meet objectives rather than allowing them to emerge from calculated surplus. Interim rates in respect of pensions business were increased for 1979. This was the area in which marketing was concentrated, and the increase improved the Society's competitive position.

46. On 20 December 1978, the Board approved interim bonus rates for 1979 on the basis of reports by Sherlock and Ranson. Ranson said that the investment experience of the fund and the differential impact of tax on the various elements of it had resulted in the untaxed fund earning more than was paid to policyholders of that class. Their interim rates should be increased. The taxed fund continued to "pre-empt some capital appreciation", but the untaxed fund required no support from capital. Sherlock agreed with Ranson. His comments were:

> "It is evident that pension policies which become payable before 31.12.79 will have received an inadequate share of revenue surplus (and no share of capital appreciation) unless a change is made.
>
> It will become evident to the actuary to the USS once he is instructed during 1979 to consider the future of former FSSU policies issued by the Society that they are not receiving their fair share of surplus and that would make the case for their long term maintenance difficult.
>
> It seems undesirable to include in our pension policy illustrations bonus rates which might put us at a disadvantage against the market when, as at present, they do not properly reflect the earning capacity of those policies."

A reason had been found to increase rates for the class of business the Society wanted to develop. The bonus rates were based on "general" considerations, backed by the office model of assumptions, i.e. the bonus levels had been set at "desired" levels and tested against the model.

47. A version of the three-call system[5] was used in April 1979 to examine the internal valuation for the first two years of the triennium. The illustrations provided to the Board showed that the second call grew in value relative to the first call, not only absolutely, but also proportionately, with a corresponding impact on the funds available for terminal bonus. The discussion anticipated later advice to reduce and ultimately abandon the second call. The excess of market value over book value at 31 December 1978 was £60m. It was explained that in each example the first call implied some increase in reversionary bonus rates. The current terminal bonus of 10% implied that there had to be available a 'third call' of about £25m appreciation in the fund plus further growth. It was emphasised that the information was incomplete and views were tentative. In the 1979 reports anticipating the declaration, a pragmatic approach was again adopted to the three-call system.

48. The three-call system had become a framework for illustrating the implications of applying different interest rates. The higher the interest rate assumed, the greater the second call, and the greater the ratio of the second to the first call. At the highest rate the second call more than exhausted the capital appreciation available and left the third call negative. Only at the lowest rate assumed was there sufficient capital appreciation to cover terminal bonus at current rates. The third call was the reserve for terminal bonus, and maintaining it was an independent policy objective. The system was used to support the analysis of results using an arbitrary range of reference rates rather than actual gilt market rates. The critical reference point had ceased to be the objective market interest rate and had become instead a subjective factor selected to produce the desired spread of bonuses. The second call represented a substantial reserve for future reversionary bonuses, but on the projection was well within the capacity of the Society.

49. On 24 October 1979, the actuaries reported on the bonus rates for 1980 and the anticipated position at the end of the triennium. 1979 was likely to be healthier than 1976. Ranson stated that it had been proper to use hidden reserves to achieve a desired degree of stability in bonus rates, but that it was "desirable to take steps to restore such reserves if they have been used on a previous occasion". There was a restatement of principle. His report brought out the current surplus. He rehearsed the three-call system, and reminded the Board of the position at 31 December 1978. He explained that the 1978 valuation was based on an assessment of the present value of the liabilities with an allowance for future bonuses less the present value of future premiums with an allowance for expected expenses. The rate of interest was 8¾%. The fund was currently earning more than that rate, and the valuation was

[5] See paragraph 14 above. The 'three-call' system provided for (i) support of declared bonus from capital appreciation up to the benchmark rate of the redemption yield to maturity on gilts; (ii) reserves sufficient to support future reversionary bonus over the period when equity yields were expected to remain below the gilt yield reference level; and (iii) distribution of any surplus capital appreciation to supplement bonus as the Board thought appropriate, and in particular by terminal bonus.

expected to produce surplus more than sufficient to provide bonuses at the levels selected. There would be a shortfall in income, as forecast. There were funds available for all three calls on acceptable assumptions. But the recommendation was for a middle course. The implications for investment strategy were discussed. Earnings of 12% were assumed. Bonuses were recommended on that basis. The recommendations of the actuaries were adopted. The three-call system was applied pragmatically by adopting an interest rate that produced acceptable results.

50. The proposed 1980 declaration on the results of the triennium ended 1979 was considered on 28 November 1979 with a view to forming firm provisional views on approach. Sherlock repeated the advice previously given that it was proper to use hidden reserves to achieve a desired degree of stability and desirable to take steps to restore such reserves if they had been used. He stated that declared and interim bonuses should be set at levels that avoided cross-subsidies between classes in support of the recommendation that gross business should receive higher rates of bonus. The paper contained observations on balance within the bonus structure that anticipated later developments. The actuaries had sought to stabilise bonus rates. It was stated that surplus capital appreciation after the first and second calls should be made available as terminal bonus, allowing freedom of investment. New hidden reserves were created, and further hidden reserves would be required to restore the position to the 1977 level. It was said that if there were increases in asset value that were not related to interest rates, they should be used for increased terminal bonus. It is of some importance to note that the Board's policy at this stage, as reflected in the actuaries' reports, was to restore capital strength.

51. The main categories of business for bonus purposes were set out in the appendix to Ranson's report and their taxation status was indicated. It was disclosed that a share of the cost of growth in single premium business had been charged to the Society's universities business subsidiary USS on the ground that the demise of FSSU had precipitated the Society's need for growth. The bonus proposals were tested against an assumed surplus of £37m (including a first call of £11m). It was proposed that the terminal bonus structure should be amended. In place of the flat rate of 10%, it was proposed that there be a sliding scale from 7½% to 12½%, depending on duration between 5 and 15 years. This was a major change that was to have increasing significance over time. The selection of a fifteen-year duration for the highest level of benefit had marketing implications.

52. The estimates were up-dated for the board meeting of 19 December 1979. It was reported that the results for the year were likely to be close to forecast except in respect of market values of assets. At 31 December 1978 there had been a margin of £60m over the book value of assets. The forecast at 31 December 1979 was £34m. It was anticipated that there would be a surplus of £30 to £40m. But, interest and capital movements had "not made the proposed interim bonus less secure". It was said that investment policy had been successful over the triennium. The Society would be able to build up hidden reserves by some £6m and still declare bonuses that were fair. In paragraph 11 the report drew attention to the risk that while the first call would be covered, the second call might not be quite covered, and any amount left over would at best be trivial. Proposals for the new terminal bonus system were said to counter risks associated with substantial late contributions aimed at taking advantage of terminal bonus practice.

53. The valuation and bonus declaration report was presented on 6 February 1980. Despite the decreases in investment returns over the triennium, the financial results were considerably better than in the previous triennium. The liabilities were valued at £373m, excluding bonuses. Reversionary bonus rates were increased to 7.0%, at a cost of £52m, giving a total liabilities value of £425m. Terminal bonus was set at 1.0%. Including the guaranteed investment rate of return of 3½%, a surplus of 11⅔% (10½% guaranteed benefits) was required[6]. The Society's investments generated an average income yield of 8.6% for the triennium. There was

[6] See financial tables, table D.2.

an income shortfall of 1.9%. The shortfall was met by a call on capital appreciation of £15m. It was reported that the valuation bases were not conservative, but created hidden reserves of £6m. After providing for the guaranteed rollup rate of 3½%, the total surplus available for distribution was £57m of which £52m, representing 91% of the surplus, was distributed as declared reversionary bonuses. This surplus was derived after deducting the cost of final bonuses paid during the period of £4m from total current surplus (as reflected in the regulatory return) of £56m. An undistributed balance of £1m was brought forward, and £1m was carried forward.

54. The valuation report stated

> "If the assets are written up as recommended, the fund shown in the balance sheet will be £431m as against a total liability of £425m. This will leave a margin of about £6m which will enable us to make specific advance provision for terminal bonus payments during the next three years, a provision it has not been possible to make before. The balance will provide a rather more healthy amount of surplus carried forward than has been possible in recent years."

After audit, the balance sheet showed the fund at £430m, and the margin narrowed as indicated above. In the event, £13m was paid out in the 1982 triennium in respect to terminal bonus on maturing policies. The value of maturing terminal bonus at 31 December 1979 had been underestimated. However, the report on which the Board proceeded, uniquely, acknowledged the appropriateness of advance provision for terminal bonus payments in computing the long-term fund. This compares with earlier statements relating the amount of the terminal bonus to the third call. The comment suggests that at this stage the Society acknowledged the need, in principle, to make provision, but approached the issue as circumstantial.

55. The book value of the Society's investments at 31 December 1979, written up by the amount of the £15m call, was £421m. The out turn was better than forecast because of a sharp increase in yield. Capital appreciation on properties had been significant. Off-balance sheet capital appreciation was £33m. But the margin had narrowed. The first call had been covered on the recommended bonus. The Actuary had warned the Board that there might not be sufficient appreciation to cover the second call, and that any amount left would be trivial. In the February valuation report, the second call was not mentioned. The amount of the third call was not stated. It is clear that disclosure of an amount for the second call would have exposed the lack of cover for the terminal bonus. On earlier estimates the second call had been a minimum of £20m. The Board had resolved on bonus levels without demonstration that they met the criteria implicit in the three-call system.

56. This triennium had seen considerable recovery. But the trend in investment returns had been adverse. In the triennium as a whole, an average annual return on investment of 16.7% was achieved, and 11.5% was allocated, leaving an undistributed 5.2%. But the year on year analysis uncovers a declining solvency position behind this average. In 1977, off balance sheet capital appreciation on investments was £63m representing a solvency ratio of 23%, a material improvement on the closing position of the previous triennium. Investment returns of 38% were earned by the Society in 1977. In 1978 this position weakened to £60m, with a solvency ratio of 18%. In 1979 reserves decreased to £33m with a ratio of 8%. The actuarial valuation brought out a surplus of £57m of which £52m was paid out by way of bonus declarations. The Board increased declared bonus rates from 5¼% to 6½% for general business and from 6½% to 7% for pension business. The increase was largely in line with the increase in the gilt yield. The Society's actual yield over this period increased from 8¾% to 9%, a one-half percent increase compared to a market rise of one percent. There was a greater reliance on capital appreciation as the income shortfall increased.

Bonus policy in the 1980s

The 1980 – 1982 Triennium

57. In the triennium 1980 to 1982 the pursuit of growth continued. The president's statement to members in the accounts for 1980 related growth to competitive position. The increase in total new renewable premium income for 1980 was 31%, against an increase for the industry as a whole of 16%. The Society was said to be amongst the ten largest life offices in terms of new renewable premium income written in the UK. Cash proceeds of maturing with-profits endowment and pension policies were higher than ever before and it was said that the Society's policies continued to feature very favourably in independent surveys of results under maturing policies. Press comment had drawn the attention of the wider public to the excellent benefits provided by the Society's policies and contributed to the increase in their new business, an increase which exceeded the forecast for the year. 1981 and 1982 each produced further growth. At 31 December 1982 the total fund value exceeded £1 billion.

58. In his final statement to members, in the 1981 accounts, Caldecott commented on the substantial growth achieved over his term of office. The present senior management team had been established by 1975 and, he said, there were already signs at that time that the Society was about to move ahead rapidly. Total premium income from all sources in 1975 was £25m against £120m in 1981. The fund at the end of 1975 was £213m compared to £668m. The Society had achieved a substantial increase in total new renewable premium income, the figure in 1981 being 30% compared to 19.5% for the industry in the UK as a whole. The president stated that 1981 had proved to be a difficult market for offices generally. The Society was presented as a relative as well as an absolute success.

59. The new president, David Murison, presented his first report in the 1982 accounts. He celebrated 1982 as a year of substantial progress. The Society's low expense ratio had been a factor. The level of commission payments by others had attracted adverse press comment. People were increasingly aware that the Society did not pay commission. He said that over 18,000 policyholders were introduced to the Society in 1982, significantly more than in any previous year. At 31 December 1982, the balance sheet, for the first time, recorded assets at market value on bases consistent with those required for returns under the Insurance Companies' Act, and showed an investment reserve substantially larger at the end of 1982 than a year earlier.

60. Investment returns over the triennium were good and that enabled the Board to declare higher bonus rates. It was also considered appropriate to increase terminal bonus rates, particularly at longer policy durations. The unchanged interim bonus rates reflected the Board's uncertain view over future interest rates and associated investment returns. By 31 December 1982 the Society was in a strong position with an investment reserve of £204m. The financial position over the triennium is summarised in table 3.4 opposite. The Society ended the triennium with no material net current assets. The investments, at market value, equalled the net asset value of £1.1 billion, and that sum was matched by a long-term business fund of £882m and an investment reserve of £200m, which represented a solvency ratio of 22%. At the end of 1979 the level had been 8%, rising to 16% at the end of 1980. The ratio decreased to 13% in 1981 before increasing to the final level of 22%[7].

61. Sherlock summarised experience, the Society's corporate objectives, and plans for the future on 26 March 1980. His report stated that the Society's experience had been more favourable than expected in the forecasts of September 1976. Expenses had been better controlled, marketing had been more cost-effective and administration costs had been reduced. There had been changes in the Society's market. At the end of the triennium there was surplus capital appreciation. Progress

[7] See financial tables, tables C.2 and 3.

had been made towards restoring inner reserves. Projections for the new triennium produced yields of around 11% a year, giving year on year growth of around £110m, £130m and £160m.

Table 3.4: abridged balance sheet for the 1980-82 triennium

	1980 £m	1981 £m	1982 £m
Investments	523.1	654.2	1,085.3
Current assets	17.8	22.2	39.0
Total assets	540.9	676.4	1,124.3
Current liabilities	6.7	8.4	38.7
Net assets	**534.2**	**668.0**	**1,085.6**
Long-term business fund	**534.2**	**668.0**	881.9
Investment reserve	-	-	203.7
Total fund value	**534.2**	**668.0**	**1,085.6**
Off (1982: On) balance sheet reserves:			
- Opening position	33.3	84.9	86.8
- Movement	51.6	1.9	161.9
- Capital appreciation treated as surplus	-	-	(45.0)
- Closing position	**84.9**	**86.8**	**203.7**

62. Sherlock said that to maintain the current levels of reversionary bonuses a return of 12% was required. The deficiency at the end of the triennium requiring appropriation of capital appreciation would be £19m. Current interest levels were above 12%, and the members could well expect higher bonuses. But if the yield on the fund did not increase, the Society would once again be over-dependent on capital appreciation. The paper made clear the need to invest so as to maintain the relationship between guaranteed liabilities and fixed interest securities. The Board were advised to invest at least 60% of new money in fixed interest assets. The corporate objective remained the same, expansion being implicit in that objective. It was reported that management proposed quite dramatic increases in staff and business over the decade 1980 to 1990.

63. Towards the end of 1980, management began discussions on bonus strategy and proposals emerged for increasing terminal bonus scales to favour longer durations. The topic was considered at the board meeting of 26 November 1980. The report summarised recent valuation methods. At 31 December 1979, allowing for the write-up of capital appreciation of £15m, there had been a surplus of £57m of which £52m was declared as bonus. Half of the un-recouped procuration expenses on recurrent single premium business had been debited to surplus available on that class of business, half to the surplus otherwise available on USS business "which to a large extent created the Society's need for growth in this area." It was recommended that capital appreciation should be written up for terminal bonus paid, since amounts paid were becoming significant.

64. The proposals assumed that declared bonus rates would be at a level requiring a yield that was not materially above the running yield on the fund. That assumption was consistent with the Society's current experience. There was emphasis on increasing terminal bonus, requiring a larger 'third call' that exposed a higher proportion of total returns to market volatility.

65. When the actuaries reported to the Board on 25 February 1981 on the internal valuation for 1980, they placed significant emphasis on the Board's right under article 65 of the Society's articles of association to vary interim and terminal bonus rates. The persistent advice thereafter to increase terminal bonus was invariably associated with a cross reference to the article. The inquiry did not discover any

legal advice on the extent of the Board's right to alter terminal bonus. It would have been prudent at this stage, if not before, to have sought advice on the interpretation of the articles, and in particular whether the Board was entitled to create a bonus which appeared to have characteristics between those of a reversionary bonus provided for in article 65(1) and the additional or special bonuses that might be paid in "necessary or desirable" circumstances in terms of article 65(2). It would have been at least arguable that article 65(2) required an assessment of the circumstances at the date of payment, and that the relevant circumstances could not be anticipated. There is no evidence that any issue was identified.

66. The internal annual valuation at 31 December 1980 was reported on 25 February 1981. Sherlock endorsed Ranson's report and recommendations. The valuation had brought out a surplus of over £28m. To augment the fund to allow a bonus based on 12% would require capital appreciation of over £5m to be brought into account. The bonus at current rates would cost just under £28m, giving a surplus unallocated of £6m including the amount of £1m brought forward. It was proposed that at 31 December 1982 there should be annual compounding of reversionary bonuses. For any claim arising after 1 March 1981, the same approach should be taken to interim bonus. Ranson's report contained recommendations that the Board should retain the right to vary interim and terminal bonus rates, and, under reference to article 65, the general right to decide from time to time the principles and methods upon which surplus should be divided. The approach recommended was said to be more "natural". New legislation would require annual valuations and that would lead to annual declarations. On 25 February the Board adopted these proposals. Sherlock's report stated that the Board should "retain the general right" to decide from time to time the principles and methods of dividing surplus. It appears that it was about this time that the germ of the idea was planted that terminal bonus could be allocated and paid on current maturities without any degree of commitment to the future. The difference on formulation between Sherlock and Ranson reflected the latter's more assertive approach in matters of discretion generally.

67. A report on the relationship between assets and liabilities and investment policy was presented by Sherlock on 23 September 1981. In the reprise of recent history the report noted the decision of the Board to restore hidden reserves against the possibility of future problems. The report referred to the risks associated with dependence on capital appreciation, by reference to the position at 1973. It commented on the release of hidden reserves in 1976, and recorded that the hidden reserves were being restored gradually as a precaution in case a similar problem arose in the future. The paper discussed the theoretical considerations influencing the balance of fixed interest and equity holdings. A practical solution was proposed that investments should be balanced to achieve a yield on the fund "not significantly more than 1% below the yield required to support bonus levels." At that level one-eighth of the total surplus required for bonus would have to be generated by capital appreciation, and that was said to be an acceptable risk. The margin reflected clearly an approach that had been developed internally by staff in the actuarial department, and in particular by David Driscoll. Driscoll was not a qualified actuary, but played a significant role, and was to be one of the co-authors of *With Profits Without Mystery*, the Society's statement of practice published at the end of the decade[8]. The restoration of hidden reserves reflected the continuing policy of attempting to restore the strength that had been lost over the period from 1973 to 1976 and represented the Board's and Sherlock's management policy at that time.

68. On 28 October 1981, Ranson submitted a report on the interim bonus rates for 1982. The structure of the report followed previous patterns, with rather less discussion of the basis of the recommendation. Long-term interest rates were rising. Market values had been fluctuating widely. Sherlock in his report emphasised the need to keep rates under review because of changing circumstances. He referred to

[8] See next chapter.

the possibility of meeting the cost of bonuses from "a reduction in the pace of building up inner reserves" as an alternative to increased investment income and capital appreciation. He supported Ranson's recommendation of a limited change in interim rates. Ranson's report contained the now typical rehearsal of recent policy and history. There was little discussion in the report. There was no discussion of the reduction in building up hidden reserves. The change of emphasis reflected in Sherlock's observations was not noted. The Board accepted the recommendation that interim bonus rates for recurrent single premium business be increased and that all other interim and terminal bonus rates remain the same for 1982, subject to the right to amend should circumstances so require.

69. On 25 November 1981 the Board received a report on investment in 1982. By then it had become apparent that the Society would not achieve an investment yield within 1% of the 'target' of 12% on which the declared rate was based. Close adherence to the guideline of a one-eighth capital appreciation contribution to bonus would be impracticable for 1982. It was recommended that the Board should accept a greater reliance on capital appreciation and adjust investment policy accordingly. The Board agreed. This report effectively acknowledged the impracticability of the investment strategy previously set down, and moved towards a policy that accepted increased dependence on capital appreciation to maintain declared bonus levels. Pragmatism had overtaken principle once more, with an explicit acknowledgment that capital appreciation was required to sustain distribution policy.

70. The internal valuation at 31 December 1981 was placed before the Board on 24 February 1982. The surplus of £55m was supplemented by a first call of £11.5m and capital to meet the cost of terminal bonus paid of £3.5m. The amount required for the second call was £10m. The excess of market values over balance sheet values at 31 December 1991 was £92m. In the light of these figures, it was said that current terminal bonus rates were still appropriate. It was also said that there was evidence that current and continuing earning power of the fund might support higher bonus levels. Review of bonus policy continued.

71. In January 1982 Ranson was appointed joint actuary of the Society and succeeded Sherlock as appointed actuary for regulatory purposes. In his new capacities, he presented a report dated 26 May 1982, entitled 'Review of approach to bonuses in changing financial conditions', which was "noted" by the Board on 23 June. The report rehearsed the Board's distribution policies that declared bonuses emerging should be inherently stable; that gradual change in response to changing financial conditions was more acceptable than severe fluctuations from one bonus declaration to the next; that interim bonus rates should similarly be stable; that the greater part of the surplus emerging should be distributed by way of declared bonus; and that the terminal bonus system recognised that part of the surplus emerging through capital appreciation was likely to be more volatile and less suitable for distribution by way of declared bonus. The paper discussed likely levels of declared bonus looking forward.

72. The call system was rehearsed. Despite changes in its application, it was expressed, briefly, in conventional terms. The report set out details of valuation practice and experience since 1971. It stated that basing the 1979 model on a slightly higher yield would not have led to instability in declared and interim bonus rates in the current triennium, and that:

> "It is clear that maintaining the fixed interest model on the 12% basis for the current triennium might in its turn lead to too small a proportion of the surplus being allocated as declared bonus and the relationship between declared and terminal bonuses might begin to get out of balance."

It was said to be probable that, having regard to likely earnings, a higher base rate would be recommended based on a rate of 12½%, a rate that could be maintained for at least the next triennium. The likely average yield had the fund been 100% fixed interest would have been 13½%. The selection of 12½% illustrated the earlier advice to depart from the benchmark in favour of a desired rate. Ranson said that

12½%, would probably lead to too low a proportion of the total surplus emerging by way of declared bonus. In the circumstances it was necessary to consider some form of special declared bonus to maintain balance. This signalled the start of pressure towards increasing distributions.

73. The 1982 declaration was anticipated in a report dated 24 November. By then there had been a sharp decline in interest rates to 10½%. The account of bonus philosophy was consistent with earlier descriptions of the three-call system. There was reference back to the May 1982 paper, and a suggestion of under-declaration and distortion as between reversionary and terminal bonuses. Financial conditions were said to be changing. The report noted that within the last three months, interest rates had suffered a sharp and significant decline. The investment committee had expressed the view that the outlook for interest rates was uncertain in the time-scale with which the Board were concerned. Bonus strategy therefore, needed to be able to react to varying interest climates:

> "5. ... If a "permanent" fall is taking place we need a strategy which will enable bonuses to fall to the new lower level in an orderly fashion but at a pace which will seem acceptable to our existing policyholders. If interest rates continue to decline the pace of reduction of bonus rates will need to be rather faster.
>
> Clearly, if interest rates revert to the range of 12% to 15%, current bonus rates will again be earned and the fall will be seen as a fluctuation downwards similar to the fluctuations upwards to very high interest rates in 1974. These fluctuations are normally smoothed and not reflected directly in bonus rates.
>
> In the light of the uncertainties about the future because of interest rates, it seems appropriate in considering declared, interim and terminal bonus rates to avoid recommendations which clearly presume one or other of the alternative pictures. At the same time, it is in my view important that we should not on this occasion hold back surplus which should be allocated as declared bonus.
>
> 6. If the recommendation in the previous paragraph is accepted, then declared bonus rates should essentially pass on surplus which has been earned during the triennium. The recent change in financial conditions need have no direct effect."

This comment anticipated the development of 'full distribution' as Board policy that was to come into prominence later in the decade.

74. The approach reflected in the report resulted in a recommendation of a distribution rate based on a desired rate of 13¼%, with a first call of 2¼% of the fund per annum. Current interim bonus rates would be based on the same figure. The report proceeded to set out the results on the three-call approach. At 31 December 1982, the balance sheet value of the fund was likely to be £830m. If interest rates were then about 10%, the total appreciation in the assets was likely to be about £240m. The report stated:

> "On the bonus strategies outlined earlier, this could be utilised as follows:

First call	£ 45m	Amount required to take earnings on fund up to 13¼% p.a. for the triennium.
Second call	£104m	Shortfall in earnings for the future
Third Call	£ 91m	Available for terminal bonus
Total	£240m	

> This disposition of the capital appreciation showed a markedly different picture from earlier declarations. The second call is, on the basis defined, a substantial amount and can be thought of as a direct reflection of the capital appreciation arising from the fall in interest rates. This is perhaps another way

> of demonstrating that for a long term fund the apparent benefit of the rise in market value of fixed interest investments is illusory. In practice many of our fixed interest investments are now standing above par and will be redeemed at a lower price than their current worth.
>
> The amount of the third call on the basis of the calculations set out above, namely £91m, is fully consistent with the current terminal bonus rates. I recommend, therefore, that terminal bonus levels should remain unchanged except that rates appropriate to both short and long term policies need further study before a final recommendation can be made."

Reservations were then expressed about the strategy should interest rates change materially. In relative terms, the amount of the second call had increased significantly, in line with the general theory. The increase in declared rates was material.

75. The revenue surplus earned was at that time estimated at 11%. Appropriation of capital appreciation of £45m would raise distributable surplus to 13¼% and that would allow an increase of pensions business bonus rates to 9¼%, with an on-going interim rate of 8½% for the following triennium. Ranson calculated a second call of £104m by postulating reducing rates of interim bonus from 8½% for the following triennium to 7½% for the following triennium and 6½% for the third triennium. He observed that if bonus rates were maintained, the revenue shortfall, and therefore the second call, would continue to grow. On the then current projections, the exercise left a substantial sum available for a third call for terminal bonus. This analysis was presented as an application of the three-call system as approved in 1973. But it had changed the formulation of the second call from a projection of revenue deficiencies expressed as a capital sum to a projection of desired levels of reversionary bonus. This change facilitated the reduction and eventual abandonment of the second call.

76. Having regard only to its terms, the February report appeared to have reflected the three-call system in full operation, with prudent reserving against future revenue deficits, full provision for current bonuses and full recognition of the future cost of terminal bonuses. The Society's advertised policy at the time continued to be to declare reversionary bonuses benchmarked off long-term market gilt yields. So far, the first call dealt with the shortfall as it arose. Given the Society's investment strategy, future income shortfall was predictable. The actuary could calculate the capital value that would yield that amount of anticipated future income shortfall. The declared policy had been to set aside the resultant value when capital appreciation was available. The substitution of target rates of future bonus was a material change.

77. In a report for the Board on 26 January 1983, Ranson updated the financial information. Interest rates had recovered to 11%. He revised the projected bonus levels and reduced the amount of the second call, increasing the third call accordingly. He said:

> "9. As described... above, the "second call" on the appreciation is earmarked to cover future shortfalls in income and the balance, the "third call" is available for distribution by way of terminal bonus. ..."

78. The figures reported in November 1982 were set out and expanded to show that the second call comprised two elements: the sum of £54m for 1984-85, and the sum of £50m for 1986-88. The second call had become a measure of the support required for desired levels of bonus over a finite period. The report identified the likely growth in terminal bonus as a feature of future practice. The revised approach reduced the value of the second call and released more of the surplus for the third call. The assumption in the paper appears to have been that reversionary bonus rates would fall over the time frame of the projection. That would point to a reduced need to protect future bonus payments. But, if that were the idea, it appears that instead of an arithmetical projection of the revenue shortfall until equity investment

returns rose to the required level, expressed in terms of a capital reserve, the second call had come to be a measure of the amount required to support bonuses at a desired level out of unrealised capital appreciation.

79. Paragraph 16 revised the figures to reflect changed expectations:

"In the event, interest rates were about 11% at the year end with appreciation in the assets of about £250m. If interest rates were to remain at this level then bonuses would eventually need to fall from the current level of £8.50% to £8.00% in the second triennium and then to about £7.50%."

The figures derived were:

Appreciation in fund	"First call"	"Second call"			"Third call"
		1983 - 85	1986 – 88	1989 onwards	
£250m	£45m	£45m	£35m	Self-supporting	£125m

The revision in approach moved significant value from the prudent reserve for future income deficiencies to the third call for terminal bonus. This appears to have been a deliberate step away from the theoretical established position on reserving. Paragraph 17 of the report referred to the risk of loss of market position if the Society did not augment benefits to current members.

80. The report proceeded to move even further from that position. Ranson drew attention to the marketing context, and proposed a significant amendment to the second call calculation:

"... We have now seen press announcements of increased declared rates and higher terminal bonus rates from several leading offices. It appears therefore that some of the appreciation in assets consequent on the fall in interest rates is being used to augment benefits for current policyholders. If we disregard this point we shall tend to be out of step with our competitors and our relative position in the tables of actual results might well be prejudiced despite the increase in declared rates which has already been recommended.

Having reviewed the situation in the light of what the market is doing, I now recommend that we move a little way from the position previously recommended and that for the most recent model described... above we do not look beyond the end of the triennium 1983 to 1985 for any explicit supporting of bonus rates. If the 11% interest rate climate persisted then bonuses would fall from £8.50% to £7.50% in 1986 rather than 1989. In consequence the second call for the triennium 1986-88 would be unnecessary increasing the third call from £125m to £160m."

Appreciation in market values of assets was to be earmarked for terminal bonus. The operation of the call system, adjusted for the changes in policy, was illustrated as in table 3.5.

Table 3.5: Operation of the 3-call system for 1982 triennium

Calls 1980 – 1982	**Available for distribution**	**Reserved**	**Total**
1st call	£45.0m	-	£45.0m
2nd call	-	£45.0m	£45.0m
3rd call	-	£160.0m	£160.0m
Total	**£45.0m**	**£205.0m**	**£250.0m**

This reflected the start of a process of material change in reserving practice that was soon to lead to abandonment of the second call altogether, with a corresponding inflation of the fund available for terminal bonus on practice at that stage.

81. Through the triennium the return had averaged 20% per annum, resulting in capital appreciation of around £250m of which £45m was required to meet the first call for an income shortfall of 2¼% per annum. £45m was reserved to meet future expected second call income shortfall in the following triennium and the remaining £160m was reserved for the third call. In 1980 the explicit general reserve for expenses was increased by a further £4m to £10m. The change in accounting policy to expressing assets at market value 1982 resulted in the requirement for assets to be written up by £91m to their respective market values at the beginning of the year. During the year assets and income were written up by a further £45m (1979 - £15m) for the first call. The remaining £205m (1979 - £35m) of capital appreciation appeared for the first time in the Society's history as reserves on the balance sheet. All capital appreciation was now reflected in the accounts.

82. The Insurance Companies Act 1982 required valuation results to be formally reported to DTI each year, from and including 1982.

83. The restriction of the second call to revenue deficits anticipated in the next following triennium, rather than over the period necessary to equalise equity and fixed interest returns, was a material step away from the theory of prudent reserving previously adopted as policy. The only reason of substance set out was a response to market pressures as set out in the quotation in paragraph 80 above. The decision to increase declared rates, against the background of a general pre-disposition to reduce distributions, was a response to competitive pressures.

84. The significance of the report was that it reduced materially the value of the second call and correspondingly increased the value of the third call and therefore the amount available for distribution by way of terminal bonus. Arithmetically, an increase from the current levels based on 15% to rates based on 20% would be appropriate, but recommended an intermediate rate for practical purposes of 17½% and the Board proceeded on that basis. There had been a material shift towards terminal bonus in the overall mix.

The 1983 – 1985 Triennium

85. The president's statement in the 1983 accounts reported that the results were a record: new annual premiums were increased by 46% from £45m to £66m, while new single premiums at £48m were 95% above those of 1982. A high proportion of the new business resulted from introductions and recommendations from existing policyholders. Consulting actuaries and pension consultants also introduced a considerable volume of new business and almost 20% of new premium income related to clients introduced by accountants and solicitors. The financial planning service also played a significant part in growth during the year.

86. In his report to members in the 1984 accounts, the president commented that it had been a tough year. But there had been excellent results: new renewable premium income had increased by 20% over 1983. The statement in the 1985 accounts was David Murison's last as president. He commented on success in controlling expenses, and the Society's long-established reputation for economical operation, "the envy of other life companies", and the generation of business without commission, by professional intermediaries. In 1985, the market value of the Society's assets at the year-end exceeded £2 billion for the first time. The total investment return on the fund was higher than at the previous bonus declaration and accordingly the Society felt it appropriate to increase bonus allocations further. He continued:

> "In considering the form of the increase, the investment implications of alternatives are important. Since reversionary bonuses, once declared, are fully guaranteed they need to be backed by fixed interest investments, such as gilts; but we believe that it is in the best interests of members that we should

be able to invest extensively in equities and properties. With that background it was a question of deciding what proportion of the increase, if any, should be allocated as reversionary bonus. The problem is one of balance. After very careful consideration, your Directors decided that we should maintain the high reversionary bonus level declared three years ago and adopt significantly higher terminal bonus rates for 1986."

87. The Society's Companies Act accounts are summarised in table 3.6 below. Net assets grew by £1.2 billion, representing total net asset growth of 107% over the triennium, with values increasing by 32%, 28% and 23% in 1983, 1984 and 1985 respectively. Total premium income was received (net of reinsurance) of £786m. Premiums grew from £219m in 1983 (40% increase over the previous year) to £263m in 1984 (20% increase) and thereafter to over £300m in 1985 (15% increase). Total growth in annual premium income over this triennium was 94%, with 1985 premium income being nearly double that of 1982[9]. The Society received investment income of £95m, £120m and £150m for the respective years of the triennium. The disclosed investment yield achieved was 10.0%, 9.9% and 7.4% for years 1983 to 1985 respectively. The aggregate surplus of income over expenditure for the triennium was £780m (1980-82: £410m), which represented net new money available for investment. A total of £125m (1982 - £45m) in capital appreciation was transferred from the investment reserve to the profit and loss account, which was used to augment the actuarially determined surplus.

Table 3.6: abridged balance sheet for the 1983-85 triennium

	1983 £m	**1984 £m**	**1985 £m**
Investments at market value	1,425.9	1,805.7	2,213.1
Current assets	45.7	76.8	76.6
Total assets	1,471.6	1,882.5	2,289.7
Current liabilities	34.9	49.2	43.3
Net assets	**1,436.7**	**1,833.3**	**2,246.4**
Long-term business fund	1,099.4	1,366.5	1,810.6
Investment reserve	337.3	466.8	435.8
Total fund value	**1,436.7**	**1,833.3**	**2,246.4**
Investment reserves:			
- Opening position	203.7	337.3	466.8
- Movement	133.6	129.5	94.0
- Capital appreciation treated as surplus	-	-	(125.0)
- Closing position	**337.3**	**466.8**	**435.8**

88. At the beginning of this triennium, the published accounts showed the Society in a strong position. It had reserves of over £200m, including the revaluation gain arising on the change of accounting policy, and a solvency margin of 22%. Declared rates at 1982 had effectively passed on earnings equivalent to 13¼%. Interim bonus rates forward were set at £12½% "in an uncertain interest rate climate in which 12½% was no longer obtainable". There had been capital appreciation in the latter part of 1982, and it was intended that recourse would be had to that if there were a shortfall in earnings in 1983. It was appreciated that if the interest rates stabilised at the level of autumn 1982, "there would be clear implications for bonus strategy". Bonuses would have to fall to the new level in an orderly fashion. If rates returned to former levels, the fluctuations would be smoothed out. Interim bonus levels were maintained on 26 January 1983.

[9] See financial tables, table B.3.

89. Interim bonuses for 1984 were the subject of a report by Ranson dated 16 November 1983 for presentation to the Board on 23 November. The paper discussed the Society's approach to bonus in familiar terms. It set out a "reminder" of fund performance and agreed bonus strategy for the last triennium and beyond. It repeated the discussion in the report of 24 November 1982 about the implications of changes in interest climate. He advised that interim and terminal bonuses to December 1985 should remain broadly at current rates unless circumstances rendered that strategy untenable or inappropriate.

90. The Board was advised that capital appreciation was available to support interim rates at existing levels. The cost of support through to the end of the triennium was calculated at £65m (which compared with the second call of £45m calculated in December 1982). Allowing for that increase, there remained substantial capital appreciation, and it was recommended that terminal bonus rates should be increased to 20%. Ranson proceeded to rehearse the call system as it had developed, making it clear that the calculation of the second call was now based firstly on a view as to the level of bonuses that was likely to be sustainable over the future and second, a view as to the likely future earning power of the existing fund. In the current investment climate new money could probably not be invested to match the earnings required to maintain interim bonus levels unchanged. That had led to the view that the second call should be based on supporting bonuses to the end of the new triennium. For the year to 31 December 1983 capital appreciation of 2% was required to augment revenue if interim bonus levels were to be covered. It was expected that if the anticipated shortfall in revenue of £20m were maintained through the triennium, the second call would prove to be short of what was required.

91. Paragraph 21 of the report set out the arithmetical implications. £20m of capital appreciation had to be treated as a first call for the current year, and £45m as the revised form of second call for 1984 and 1985, making the first and second calls for the support of bonus payments £65m. The third call of £210m represented roughly 25% of the expected with-profits reserve at the end of the triennium. That was taken as the crude level of terminal bonus appropriate for a ten-year policy subject to averaging with the previous triennium. An increase to 20% in terminal bonus was recommended. There had been a further significant stage in the development of bonus structures. It is necessary to note that the crude level of terminal bonus, before any smoothing, was now related more or less directly to the investment reserve.

92. The proposed increase in terminal bonus took into account the direction the market was taking at the time. It was said that competitive forces favoured increasing the terminal bonus. There was a trend towards more terminal bonus among a number of leading life offices. Ranson referred back to the January board meeting and wrote:

> "Directors will recall that in view of this [the trend towards more terminal bonus] I recommended a minor modification to our previously determined terminal bonus strategy. Evidence continues to accumulate that increases in terminal bonuses are being made and our competitive position in the performance tables is tending to be eroded. Whilst I would not recommend changes to our strategies simply on account of market pressure, I do believe that we should heed the market where alternative courses of action are possible. My point here is that we could either improve our terminal bonus rates marginally ..., or hold back in order to support bonuses to a limited extent beyond 1985 - and a case could be argued on both accounts. In January we decided to restrict the support of future bonuses and I recommend no change to that strategy. This has the consequence that terminal bonuses can be improved for policies leaving the fund now. This approach is in line with the market."

93. There was a further review of bonus for the board meeting on 25 January 1984. At the forefront of the advice was an assessment of the market. In November, Ranson said, he had assumed an unchanged approach for 1984 by other offices. But it had become clear that there had been change. There was a "more active approach to the determination of bonuses". Ranson said that there was no absolute in terms of bonus. Each office would bear in mind what others were doing. The life office actuary would respond to changes in the market place, whilst still attempting to hold the balance between the various generations of policyholders. Ever since 1974 the Society had headed one table of comparative performance for ten-year endowment assurances. For 1984 the Society was in fifth place. The Society's position in the tables of actual results was likely to be severely eroded for all classes of business. The financial history of the Society was analysed, and the conclusion reached that returns were running behind the full earnings on the fund. The question he posed was whether there was too much smoothing, whether the bonus policy was too conservative. It is clear that the January 1984 report was heavily influenced by market considerations and the Society's perception of its competitive position.

94. The financial results assumed in the November paper were revised upwards to reflect experience. The excess of market values over balance sheet values was increased from £275m to £340m. There was no increase in the first and second calls. The third call was increased accordingly to £275m. The crude rate for the year was increased to 30%, rather than the 25% used in November, and the averaging process brought out a figure increased from 20% to 22%. Ranson then recommended that the second call be abandoned. The reasoning in support of the recommendation is obscure. Ranson said:

> "The setting aside of the 'second call' ... as a reserve to be brought into account, if necessary, at the next valuation for allocation by way of declared reversionary bonuses is consistent with our practice developed over the years. It could, however, be said to deprive members leaving the fund before that date of their share of this amount of appreciation. This possible deprivation is a direct result of attempts to stabilise terminal bonus rates over and above the averaging implicit in the utilisation of the 'third call' crude rates."

The second call could only be said to deprive members leaving the fund of a share of the appreciation if it were first considered that accruing capital appreciation was generally available for current appropriation. That ran counter to the basis of distribution policy over a long period. But it may have been implicit in this advice.

95. A revised terminal bonus rate of 27½% was recommended. Apart from market-driven considerations, the view that the second call ignored future capital appreciation which could make the second call unnecessary implied that there was no need to retain capital appreciation already accrued to offset future revenue deficits. The contention is not easy to understand in the context of the three-call system. The system had its origins in board policies that emphasised the need to hold reserves for a range of purposes, and were conservative to a material degree in retaining capital appreciation. The recommendations were accepted. There had been a gradual development of distribution policy in a succession of reports, each purporting to move the policy forward incrementally as a marginal change in accepted policy and practice. Objectively, the period from the end of 1982 through to early 1984 saw a momentous change in the Board's policy, largely for competitive reasons, that laid the basis for the Society's subsequent weakening. But this was not apparent from published information. The release of the second call reserve increased the amount available for allocation as terminal bonus, and increased substantially the amounts credited on maturities, surrenders and transfers.

96. The second call had been related to maintaining reversionary bonus rates. The reference to stabilising terminal bonus rates is difficult to understand in this context. Prima facic providing a second call concentrated the impact of market volatility on the residual third call, and played no part in stabilising terminal bonus.

Shifting value between the calls increased the terminal bonus pool, but it did not remove the volatility implicit in equity values. There is no record of any challenge by the Board. Ranson re-calculated the base rates for terminal bonus excluding a second call and recommended increasing the terminal bonus reference rate to 27½% as already mentioned.

97. In an undated report on the 1983 results, final subject to audit, Ranson commented on the valuation of liabilities. The value included an explicit reserve of £14m. Of this, £10m was built up prior to the 1983 declaration and was held as a general reserve against expenses. The additional £4m arose from a change in accounting practice in the 1982 accounts. The Board decided then that this should not fall into surplus and should be reserved for use as might be decided in due course. The report discussed the mechanics by which hidden reserves had been created, and the consequence, that surplus had been understated. Ranson indicated that he intended to change the valuation bases to avoid the unintentional creation of hidden reserves. The process of increasing distributable surplus was continuing. In relation to terminal bonus, he commented that surplus for the year was depleted by terminal bonuses amounting to about £5m paid out during the year. He said that terminal bonus should be charged to capital rather than revenue.

98. The process continued for the 1985 interim and terminal bonus rates. Interim rates were maintained at existing levels. On 23 January 1985 the Board approved recommendations on terminal bonus rates as from 1 January 1985. There was extensive discussion of the rates. A shortfall of £50m had developed over the first two years of the triennium that would require a first call at the 1985 valuation. On existing methodology the crude terminal bonus rate brought out on values at 31 December 1984 would be about 35% as against the previous estimate of 27½%. Following a review of the market, Ranson said that he had "felt it necessary to advise the Board that a less cautious approach to determining terminal bonuses was desirable." A rate based on 35% was represented as "fair". The actuary reported that his calculations showed that the rate could be maintained even if there were no further capital appreciation over the coming year. He made some comments of importance for the future:

> "I have... said on other occasions that terminal bonus actually costs relatively little in the way of cash because it applies only to policies leaving the fund currently. ... A case could be made in certain circumstances or to meet certain objectives for 'carrying' terminal bonus rates calculated at the extreme upper limit but unless they were set in the expectation of a rising market we should have then moved away from considerations of equity and policyholder expectations to predominantly commercial considerations."

99. In calculating the average rate 1981 had been left out of account because at 10.7% it would have had a depressing effect on the calculation. The gross return over the three selected years, 1982 1983 and 1984, had been 29.3%; 20.3% and 16.0%. The trend was downwards, but the simple average was used in calculating the bonus rate. Further the emphasis on the cash cost of terminal bonus for current maturities ignored continuing policyholders' reasonable expectations and, at extremes, was questionable. The advice was that one could react to market pressures because the immediate cash cost was low. However it was implicit in that approach that any forecasting error that resulted in over-payments to current maturities would be made good at the expense of continuing members. There would be little or no estate, and little margin for error. To the extent that there were claims reflecting full value, the risk of adverse market movements was transferred to succeeding maturities. But this was not discussed in the published statements. At the time the fund was earning less than the amounts required for bonus. It was anticipated that at the valuation at the end of the triennium there would be changes in the valuation bases as well as appropriations of capital appreciation.

100. On 27 February 1985 Ranson described the processes of valuation of a range of products. At that stage the Society was experiencing "strains" due to interim and

terminal bonus payments, reserves required for immediate annuities sold on higher rates than could be earned, new assurance business, writing off of procuration expenses incurred on new retirement annuity business, and untraced items amounting, in all, to £21m. The fund was earning less than the amounts required for bonus. With the first call of £50m, and a hypothetical declaration at 31 December 1984, there would be a net shortfall of £8m.

101. Ranson again advised that he anticipated changes in the valuation bases at the end of the triennium to reduce some of the strains implicit in the methodology and also a transfer of capital to meet the cost of terminal bonuses. There was no reference to a second call. He proceeded to deal with the third call and terminal bonus. The base rate for terminal bonus went up to 35%. The formal 1984 results were reported to the Board on 27 March 1985 and bonus rates were approved subject to verification of the asset values. The approach confirmed the importance of the change of policy in the previous year. The key words in the re-formulated bonus philosophy were equity, fairness, stability over time and the market.

102. On 27 November 1985 Ranson presented a comprehensive report on the approach to bonus allocation. The report contained information on informal discussions on bonus that had taken place on 23 October 1985. It stated:

> "3.1 The Society's approach to bonus distribution and the setting of interim and terminal bonus rates has been essentially one of 'fairness'. This concept is impossible to define in a precise way but is broadly aimed to provide a total 'bonus package' to a with-profits policyholder based on the earnings of the business during his membership of the fund. An active approach has been taken when considering the various bonus rates and their inter-relationships. Modifications have been made to methods and models used to help judgment when changing conditions have made this desirable."

103. The market position was described. In short, other offices were producing better results; the Society was no longer a clear market leader; the Society did not pay commission, therefore it needed to be self-attracting, and a slippage in the tables weakened its position. Doubt must not be cast on the benefits of mutuality. The bulk of the business was in the pensions field. Renewals of single premium pensions business were crucial. If that business were at risk ongoing new business would equally be at risk. The report stated:

> "We need to review a number of aspects of our current approach to bonus to test their continuing appropriateness. In particular, has the structure and weight of the business at various durations changed? – this has implications for individual terminal bonus rates. Is our method of valuing the pensions business creating a measure of unfairness?"

104. Section 4 of the report discussed article 65. It was said to be the directors' responsibility to instruct periodical valuation and decide on the distribution of surplus. And:

> "The same Article deals with the directors' right to pay interest or additional or special bonuses, a phrase which includes terminal bonuses."

The particular provision relied on when the terminal bonus had been introduced in 1974 had not been specified. This review identified the source relied on by Ranson for the terminal bonus system as a whole. As discussed already[10], there was room for doubt about the assertion, but no legal advice appears to have been taken. The report emphasised the dependence on bonus as the sole means of distributing benefit, and commented that bonus allocation within the fund was not a precise calculation. The report analysed the structure of the business and the changing pattern of bonuses. It commented that growth of business had been associated with shortening of the average duration in force of the business, and stated:

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[10] See paragraph 65 above.

> "6.2. The overall shortening itself obscures significant changes in the weight of the various classes of business at the various durations. The increase in business has been concentrated on the pensions type contracts and the reserves for this business show a very skew distribution by years in force, with the bulk of the business at the short end. This has implications for the calculation of individual terminal bonus rates.
>
> 6.3. Until the significant rise in terminal bonus rates from 1983 onwards, the practical effect of the changing structure of the business was minimal. This was because terminal bonus was a relatively small proportion of the total maturity value. It was possible to determine a table of individual terminal bonus rates from a base rate applicable to a policy of average duration in force for the major classes of business.
>
> 6.4. From 1983 onwards terminal bonus rates have risen appreciably. The current rates are on average double those which applied in 1982. Terminal bonus is no longer a relatively small proportion of total maturity value of a policy."

A more sophisticated methodology for determining individual terminal bonuses was said to be required. It was as a by-product of the study of this problem that the actuary formed the view that there had been under-distribution. The comments provide evidence of a contemporary assessment of the changes that had taken place over the previous few years. But they were merely a prologue to fresh proposals to increase allocation of bonus.

105. The picture painted was of relatively high rates of growth in short duration pensions business. Typically this would appear to have included high value transfers towards the end of a person's working and contributing life. At paragraph 6.7 the actuary reported that he had carried out a study of terminal bonus rates and practices to allow greater specificity in individual rates. If current practice were persisted in only 80% of the amount available for terminal bonus would be used. He had proposals to adjust the position. The report discussed the approach to reserving for liabilities and the implications for investment strategy. Reserving for recurrent single premium business was discussed:

> "7.1. The Board will be aware from previous discussions that the Society treats its recurrent single premium business as level annual premium for the purposes of procuration expenses, but values it as single premium business only. In effect, the procuration expenses are written off, although they will be recouped if the business is renewed. This is clearly very stringent because some of the business will be renewed. In other words, the valuation method quite deliberately creates 'hidden reserves'."

He concluded that an "adjustment" from hidden reserves of about 3% was possible and could release £40m for allocation as terminal bonus.

106. In section 8, the report discussed the bonus system. The author posed a question:

> "Since the bonus system is designed to pass on to a with-profits policyholder a 'fair' share of the earnings on the business during his period of membership, it might appear that provided the overall amount paid out is appropriate, then precisely how that amount is made up is not material. In other words, does it matter what the individual components of bonus, i.e. declared, interim and terminal are, provided that the aggregate amount is appropriate?"

He acknowledged that there were constraints, based on public understanding and policyholders' expectations. A significant part of earnings was expected to be passed on in the form of declared bonuses. There was an expectation of stability in general. Interim bonus levels should in general be aligned with declared bonuses. External commentators took an interest in the split. There were actuarial considerations. There had to be a balance.

107. The report discussed the Society's approach to declared bonus levels. The analysis of the 1982 position was rehearsed again. He said that there should be an orderly approach to coping with a climate of gradually reducing investment returns. 8½% should be the minimum on the established approach. The question was whether there should be an increase. At paragraph 9.8, the actuary noted that 8½% required earnings of 12½%. The fixed interest model rate was 11%. In proposing a bonus rate of 8½% the Society was being invited to depart from practice. But he said there was ample capital in the investment reserve to take the rate to 9¼%. Various options from less than 8½% to more than 9¼% were compared and discussed. The report then discussed the level of interim bonus for 1986 covering the range from below 8½% to above 8½%.

108. Terminal bonus was discussed in section 11 of the report. The report stated:

> "Directors will recall that terminal bonus rates are currently determined by relating the investment reserve (which is the excess of the market value of the assets over the value of the fund) less the 'first call' on the appreciation ... to the aggregate reserves for with profit business. This relationship determined the 'crude' terminal bonus rate."

Crude rates were averaged over three years to smooth out fluctuations to arrive at the base rate. The base rate was adjusted for policy duration and class. This was an important statement of policy and practice. At the end of 1985, one had an approach to terminal bonus that related the level allocated to the amount of the investment reserve after prior appropriations, subject to a rolling programme of smoothing. This was illustrated for 1982, 1983 and 1984, and the position at 31 December 1985 forecast. In paragraph 11.4 it was stated:

> "A comparison of these rates with those for the past few years indicates that there is little scope for justifying an increase in the base terminal bonus rate on the current occasion, using our standard approach."

109. The discussion envisaged re-structuring of the terminal bonus tables, the 'hidden reserves' adjustment, and comparative results of varying the terminal bonus position assuming unchanged reversionary and interim bonus levels. He proposed modifying individual terminal bonus rates. The result would be to improve the Society's competitive position significantly. Assuming that competitors did not change their positions:

> "For endowment assurances the results would be in the upper half of the tables of the "top ten" but in actual cash terms a significant way behind the leaders, particularly for the longer term. For retirement annuities the improvement is much more dramatic, both by way of ranking and by the closing of the cash difference between the leaders and ourselves."

110. Improvement in competitive position was said to be necessary:

> "Reference was made... to the Society's need to encourage the payment of renewal premiums under its pensions business and to maintain the general self-attractiveness of the business overall. There is some evidence that our recent apparent falling off in performance is affecting the view taken of us. Some kind of special treatment of results at the current time could be introduced to reinforce the "self-attractiveness" of our contracts. This could well be in the overall interests of the members as a whole if it prevented the loss of renewal income. Since the endowment results tend to be used as a yardstick across all classes, no matter how inappropriate, reasons could be advanced for applying that special treatment to those. There is a practical problem, however, in that any adjustments would need to be significant to make any real impression on the "league tables". Given that the bulk of our actual business is pensions orientated and that our relative position is happier with these classes, any special treatment might be restricted to those classes. This would probably be sufficient to make the marketing point that may be required for pensions business.

> 11.12. As an example, a five percentage point adjustment to the base terminal bonus rates would cost no more than £1m in 1986, other adjustments would be in proportion..."

111. In section 12 of the report, the author stated:

> "12.1. The discussion so far has been about the situation as it may be at the end of 1985, and in many respects it is immaterial precisely how the 'surplus cake' is carved up between the various components provided that the extremes are avoided. ..."

This sentiment, repeating the views expressed in his November report, which was to emerge publicly later in *With Profits Without Mystery,* was to become important in the presentation of the Board's 'philosophy' to members.

112. In looking forward, the report stated:

> "The implication of the previous comments is that the levels of maturity proceeds on policies maturing in 1986 can probably be maintained for a year or two beyond that for the longer durations, even if earnings begin to fall away. The effect on maturing policies of shorter duration will be more dramatic and will begin to impinge sooner. How long it would be appropriate or even physically possible to support bonuses from capital after about two years must depend on future conditions. If capital is used to provide a special adjustment to terminal bonuses for 1986 maturities, the amount involved is unlikely to have a material effect on the availability of capital for other purposes. The need or desirability or practicability of continuing such support would need regular review."

The limitations on high levels of distribution were identified. But perhaps of greater significance, was the emphasis on the application of capital for short term marketing purposes in the knowledge that the Society could not maintain the level of performance implied in foreseeable circumstances.

113. The Board took tentative decisions on rates of declared bonus for the triennium. The resolution recorded was:

> "The report by the Assistant General Manager and Joint Actuary was considered. It was agreed that declared bonuses based on a rate for pensions business of £9.25 per annum and interim bonuses based on £8.50 per annum might be appropriate. It was further agreed that a marketing adjustment to terminal bonus rates costing not more than £2m in aggregate in respect of pensions policies reaching their payment date in 1986 should be considered by management. These tentative decisions would be considered further following the Joint Actuary's formal report to the December Board Meeting."

The 'marketing adjustment' was to be a call on the accounting adjustment that arose in 1982.

114. On 18 December 1985, the actuary presented a follow-up paper. In relation to declared rates, the report noted that earnings for the triennium were expected to be 10% per annum. On that basis it was said that there was no reason to declare below or above 9¼%. It would therefore be appropriate to maintain interim bonus rates as before. On that basis the first call would be £125m. An earnings level of 13% was assumed as appropriate, given capital appreciation of £580m. The report stated:

> "If we write up the assets by £125m, this will reduce the expected investment reserve from £580m to £455m. After taking account of the newly declared bonus, the expected reserves for with-profits business are likely to be some £1,435m. This leads to a crude terminal bonus rate of 32% (£455m ÷ £1,435m)."

The crude rates for the triennium were 35%, 36% and 32%. The average of 34% was taken as the base rate. The more refined approach to developing individual rates

would "ensure that the individual rates when applied to the respective reserves, produce, in the aggregate, an amount equal to the capital deemed available."

115. Thus far, therefore, the report dealt with total terminal bonus as measured by the average ratios of the investment reserve to with-profits liabilities, subject to smoothing. In a triennium with a relatively low ratio in the final year, the result was over-allocation. The report proceeded to other sources of value. The amount accumulated in hidden reserves in the valuation of the single premium pension business by discounting the probability of renewal was £50m. Experience indicated that there was a renewal rate of 80%. The actuary recommended releasing 80% of the £50m and adding 3% to the crude rate, bringing out the 37% recommended. The directors were advised to "reserve the right to review the terminal bonus rates should circumstances so require". The discussion proceeded:

> "4.9. At the November Board meeting we discussed the implications for the Society's business of the growing competitiveness of some of our competitors. This was particularly of concern in respect of the major part of our business, the recurrent single premium pensions business, where we are at risk of policyholders being discouraged from renewing their contracts if the Society's results are not seen as being attractive. Whilst hidden reserves have been set up against this contingency and in financial terms there is protection, there could clearly be widespread disruption to the Society if there were a massive discontinuance of such policies. This could not possibly be in the best interests of members generally. Furthermore, new business would be seriously at risk and it has been generally accepted that healthy new business growth is also in the interests of members."

Maintaining, and growing, business may have been in the best interests of members in relation to the burden of expenses. It is less obvious that growth was in other respects necessarily of advantage to policyholders of a mutual society.

116. The report recommended a declared bonus rate of 9¼% requiring a first call on capital appreciation of £125m, 20% of the investment reserve. He recommended that interim bonus levels should be based on a pensions business rate of 8½%. Terminal bonuses would be based on £37%. The Board accepted the recommendations. The decisions meant that the Board was declaring a reversionary bonus beyond the yield on the fund, making up the shortfall from unrealised capital appreciation, declaring an interim rate that would require support from capital, and fixing terminal bonus rates that were above the crude level and required the appropriation of hidden reserves. In addition, for recurrent single premium pensions business maturing in 1986, the Board decided to add a "market adjustment" not exceeding £2m to inflate the returns for purposes of competitive advantage. The combined effect of the two reports was that the Society had adopted distribution policies that were, again, heavily dependent on capital appreciation, but more aggressive than general distribution policy would support. On any view the policy was now one of full, if not yet explicitly over-full, distribution.

117. At this stage in the development of the discussion of bonus policy, total terminal bonus was generated primarily by the investment reserve, supplemented by the release of margins in the valuation of liabilities. If those margins existed, as the actuary said, their appropriation led to a significant weakening of the Society. The formal declaration was made on 12 February 1986. In his 1985 statement to policyholders, the outgoing president, Murison, speaking of bonuses, commented that the previous year's level of reversionary bonuses was preserved to enable the Society to invest extensively in equities and properties. The Society adopted "significantly higher terminal bonus rates" than at the previous declaration. Investment freedom was a by-product of the balance between reversionary and terminal bonus. The discussions above point to marketing as the motivating factor in the bonus strategy implemented.

118. The triennium had been marked by significant changes in the Society's approach to bonus allocation. The reports presented by Ranson can be seen, with

hindsight, to have progressively led the board towards higher overall allocations, and within the aggregate, higher relative allocations of terminal bonus. By the end of the period the Society was moving towards over-allocation relative to available assets. On 21 December 1988 the actuary reported that policy proceeds had been "supported" above natural levels for the "past three years or so", indicating that a policy of over-distribution had been adopted probably from about this time. On the whole evidence available it is not possible to identify the precise point at which the pursuit of competitive advantage resulted in the adoption of bonus policies that had this result. But the lines of thought that had developed over this triennium were clearly important in leading the Board forward to that position.

1986 - the first annual declaration

119. 1986 saw a number of changes. It was the first year of office of the new president, Professor (later Sir) Roland Smith. Sherlock became the first chairman of LAUTRO, and setting up and running the organisation absorbed a considerable proportion of his mental energies. Sherlock was increasingly involved in wider industry matters, and Ranson's control of actuarial management was consolidated. Ranson took charge of the development of the Society's information systems. The establishment at Aylesbury expanded rapidly until the computer systems were fully developed. The office premises there had been expanded. An increasing proportion of the day-to-day management of the business was concentrated there under the control of Ranson. The Society changed from triennial to annual declarations of bonus. Controlled growth was re-emphasised as the guiding statement of intent. The 'managed fund' description of the with-profits operations of the Society became established, and with it the explicit adoption of full distribution and the avoidance of building up reserves "for no identifiable purpose". By the end of 1986 however, there were no significant reserves: distribution had been full if not already over-full. The statements recognised current reality and expressed it as future policy. Substantial growth was achieved.

120. The 'managed fund' presentation of the business carried significant implications for the future. The fundamental principle of with-profits business was emphasised: the pooling of risks of all types including to some degree the ups and downs of stock markets. But the context was policyholders' participation in a fund of investments being managed on their behalf, that fund being the source of the capital required for running the business. The bonus system was said to ensure that the member got a fair return overall covering the period of membership of the fund subject to uncertainty about the amount which would be paid until the last moment. This set the scene for later presentation of the business. In particular it provided a context for policyholders' expectations as the Society's marketing policy moved further into the era of personal pensions and other forms of recurrent single premium contracts where policyholders were encouraged to the view that premiums and contributions less a specified expenses deduction formed the guaranteed core of their managed fund.

121. The Society's financial position at the end of the year is summarized in table 3.7 overleaf. The Society ended the year with investments, stated at market value, of £2.8 billion and a net asset value of £2.9 billion. The net assets were represented by a long term business fund of £2.3 billion and an investment reserve of £580m. In addition to any inner reserves in liabilities, the Society had £580m (1985 - £436m) in un-appropriated reserves, which represented a solvency ratio of 25% (1985 - 24%)[11]. Net asset growth of 28% was achieved. Premium income (net of reassurances) grew from £304m in 1985 to £398m in 1986 representing total growth for the year of 31%. Premium income included £208m of new business including £107m of single premium business. Investment income was £169m, and the investment yield achieved for this year was 6.7%. The surplus of income over expenditure for the year was £360m, which represented "net new money" available for investment. A total of £115m of capital appreciation was transferred from the

[11] See financial tables, table C.3.

investment reserve to profit and loss account. £32m of this was used to cover the amount of final bonuses paid during the year. The remaining £83m of capital appreciation was applied to increase the actuarially determined surplus to £120m. Of that sum £117m was distributed to policyholders as declared bonuses and the balance of £2m was carried forward[12].

Table 3.7: abridged 1986 balance sheet

	1985 £m	1986 £m
Investments at market value	2,213.1	2,840.1
Current assets	76.6	80.7
Total assets	2,289.7	2,920.8
Current liabilities	43.3	35.5
Net assets	**2,246.4**	**2,885.3**
Long-term business fund	1,810.6	2,305.1
Investment reserve*	435.8	580.2
Total fund value	**2,246.4**	**2,885.3**
Investment reserves:		
- Opening position	466.8	435.8
- Movement	94.0	259.4
- Capital appreciation treated as surplus	(125.0)	(115.0)
- Closing position*	**435.8**	**580.2**

122. The general approach to the year was discussed in a report from Ranson on investment considerations presented on 26 March 1986. The paper stated:

> "The current strategy regarding bonuses is to maintain interim bonus rates for the year at the levels of the triennium just ended. This clearly implies an intention to declare bonuses at the end of the year at rates equal to the current interim rates at least. Such bonus levels cannot be supported at current interest rates. Consequently, the greater the proportion of new money invested in fixed interest securities, the greater the certain call on the existing investment reserve to make up for the shortfall in earnings. On the other hand, although investment of new money in equities would have the potential for higher earnings, if these did not accrue within the appropriate timescale, the call on the existing reserve would be that much greater."

123. It was expected that declaration at current interim rates would give rise to a shortfall of £45m. Terminal bonuses for the year would be £25m. Appropriation of £70m of capital appreciation was likely to be required. The report referred to the concerns of the 1970s that had arisen in a climate of high and rising interest rates. In the current situation:

> "If we are to mitigate the effect on bonuses of lower interest rates, we have actively to seek out potentially higher returns than can be obtained on fixed interest investments. We have to accept the risks of volatility of the capital value of equity type investments associated with this strategy. That risk is now easier to accept because of the current relative size of the investment reserve as compared with only a few years ago. We have a much greater potential to weather fluctuations in market values than previously."

It was said that stability might not be the prime concern because of the investment climate, the size of the reserve, and the pressures of the market place.

[12] See financial tables, table B.3.

124. The report contained observations on the general with-profits 'philosophy'. The distribution of assets held against with-profits business could be regarded as a managed fund, but one with special characteristics. Those characteristics were essentially a money back guarantee of contributions with, in some cases, a low guaranteed rate of interest, the passing on of investment returns by way of bonuses of various kinds (some of which became guaranteed) and the smoothing out of fluctuations in market performance. Another special characteristic was that recent bonus levels tended to establish an expectation for shorter term future bonus levels. The "with-profits managed fund" and its performance were the raw material that was put through "an actuarial filter" to produce policy returns. The effect of the various guarantees was no more than to introduce a broad requirement for a certain proportion of the investments to be in fixed interest securities. It was said to follow that any discussion of maximising surplus was essentially a discussion about investing to maximise the performance of the managed fund. The report stated:

> "Hence, attention needs to be directed to the appropriate asset mix from time to time as investment views change. Because the Society is still expanding rapidly, the weight of new money into the fund can have a significant effect very quickly. In other words, recent and current investment decisions significantly affect underlying and, hence, public performance."

The Board was encouraged to consider the fundamentals of with-profits business. The new language, of the 'managed fund', moderated by implicit with-profits practices such as smoothing, was soon to become fixed vocabulary of actuarial thought within the Society, as reflected in the annual accounts. The Board was generally invited to adopt a relatively high-risk investment strategy, and to base distribution policy on an expectation of capital appreciation. In cash terms, the investment reserve was relatively high at this time. The issue whether the reserve was high relative to risk was not assessed.

125. Advice on equity investment became somewhat more ambivalent later in the year. On 26 November 1986 Ranson presented a paper on bonus strategy. He expressed doubt whether the relatively high returns on equities as against fixed interest securities that had been experienced could be sustained in the longer term. It was necessary to anticipate the emergence of an "earnings climate" closer, overall, to the level of current interest rates. There was a general discussion of the full distribution policy, of the balance between reversionary and terminal bonuses, and of smoothing. The distribution policy was encapsulated thus

> "By a suitable combination of declared and interim and terminal bonuses the appropriate share of the returns earned on the assets during his membership of the fund can be passed on to each participating policyholder. Profits made on running the rest of the business are also passed on to the with-profits policyholder by way of bonuses. These are, however, not significant in relation to those bonuses generated by the investment activity.
>
> It is the management of the bonus declarations and the way in which the guaranteed benefits under a contract build up as declared bonuses are allotted which are the significant features of with-profits business."

Some other "fundamentals" of with-profits business were discussed. The conclusion of the general discussion was that there needed to be a margin in the assets to provide a buffer against adverse experience.

126. The actuarial valuation of liabilities was discussed in the report. The accepted fixed-interest model for reversionary bonuses was described. Second call reserving was no longer part of the description. In his report to the Board for 27 November 1985, the actuary had stated that recurrent single premium business was treated as level annual premium in relation to procuration expenses, which were written off accordingly, but valued as single premium business. This created hidden reserves. An "adjustment" from hidden reserves was possible. This was rationalised in November 1986:

> "The valuation of the liabilities is essentially a technical exercise. The general approach is to set up reserves on bases consistent with those in the premium bases. So far as is possible, the creation of 'hidden' reserves is avoided. In practice, given the inevitable approximations in any valuation method, their complete avoidance is impossible and over a period of years there is almost certainly some build up. At regular intervals, therefore, the valuation bases are examined and adjustments made in the light of changing circumstances. There may also, of course, be a need from time to time to make changes on purely actuarial grounds."

The value of the assets in the long term fund was taken as the difference between the assets at market value and the investment reserve. The actuary advised that the fixed interest model would continue to be used as a helpful tool, given the unreliability of performance of equity markets, but required modification. Supervisory solvency requirements meant that 1% of investment returns achieved would have to be put towards the solvency margin. That would restrict declared bonuses and increase terminal bonuses because the margin would be released at maturity. Sherlock's policy of building up hidden reserves had now been finally abandoned, as forecast by Ranson in and after 1983[13].

127. Ranson reported that in current financial conditions bonuses had to reduce over time: it was said to be necessary to adopt a strategy that would enable the Society to move towards a "lower bonus rate environment". This reverted to earlier years' advice before competitive considerations drove the Society to increase declared rates. On an assumption that the prevailing interest rate climate would be 11%, with property and equity returns of 13%, the office model indicated that a starting point for determining bonus levels would be a yield of 10%, making allowance of 1% for the impact of regulatory solvency requirements. He projected the consequences if, despite this, it were decided to maintain declared bonus rates at the level of the 1985 triennium, which required returns of about 13%. His projection showed a progressive reduction in the ratio of the investment reserve to liabilities and a progressive reduction in the adverse market movement that would be required to threaten the Society's solvency. Over four years the percentage fall required to uncover the solvency margin would fall from 28% to 10%. The reduction in the ratio of investment reserve to liabilities would threaten the terminal bonus. The Board was warned clearly and pointedly of the risks of maintaining high levels of distribution without adequate cover. The report did not contain recommendations.

128. On 17 December 1986, the Board received a further report. The actuary provided general information about the approach to determining declared bonus. He discussed the relationship of bonus and interest rates, using pension business as the reference contract. Other rates were derived actuarially. He showed that an interest rate of 11% would support a bonus rate of 6%, by deducting the guarantee of 3½%, the solvency requirement of 1%, an allowance of ¼% for expenses and a further ¼% to compensate for the crude arithmetic involved. He estimated that for 1986, earnings were likely to be about 9%. Assets were likely to show an overall return of 14%. He advised that 11% was not an unreasonable assumption to proceed on. A declared rate of 6% would be a severe cut back on the previous £9¼%. The report continued:

> "Such a severe cut-back is not feasible, for a number of reasons.
>
> (i) The interim bonus rate announced at the last declaration and paid on policies leaving the fund before the next allocation of bonus is £8.50%. It would clearly be inequitable to declare bonuses at a lower level on policies remaining in the fund – unless the Society is in a dire financial situation, which is not the case. The £8.50% for 1986 was set in the light of the declared rate of £9.25% as a first step in a possible move to lower rates, if that became necessary.

[13] See paragraph 97 above.

(ii) The equity content of the portfolio of assets continues to outperform. An earnings rate on market values over the year comfortably in excess of that required to support bonuses at 6% is almost certainly going to be achieved.

(iii) The marketing implications, both in terms of new contracts and renewals and incremental premiums on existing business, would almost certainly be severe. The recurrent single premium nature of our pensions business means that discontinuance is effectively without penalty. Hence we are at risk if clients become disenchanted with the Society's performance."

In his view the minimum rate needed to be 8½%.

129. The report stated that there had to be a managed approach to declarations. The pace of transition to lower rates required careful assessment. Writing up from capital to produce a declared rate of 8½%, consistent with the previous declaration, would weaken the balance sheet strength, but not to a significant extent. Interim bonuses could not be higher than the £7½%, which was likely to be the declared rate at December 1987. Terminal bonus was discussed at some length. But the actuary stated that there was no need for a change of approach. The calculations brought out a lower average rate than at 1985. Interim and terminal rates were illustrated. The second year of the 'marketing adjustment' (referred to in paragraph 112 above) remained available, and it was recommended that it be used differentially to provide greatest support to the longest-term policies at the discretion of the actuary[14]. The actuary also proposed the amalgamation of the interim and terminal bonuses for presentational purposes. There was a change to the reference period for the operation of the new rates. The returns had been falling from 1984, from 36% to 31% to the current year's 28%. It was against this background that the Board considered the decision to take the "smoothed" average as a starting point for terminal bonus. The actuary reviewed his recommendations:

"The various recommendations taken together should enable a not unattractive package to be presented.

(i) The declared rate is at the level of the 1986 interim rate and hence is not a cut in rates; it is a confirmation of existing rates.

(ii) In terms of actual results, for durations of 10 and over, results in 1987 will be at least as good as those of 1986. It is only in respect of very short durations that there will be a marginal cut-back. This should be seen as not unreasonable in the light of recent earnings.

(iii) The proposed amalgamation of interim and terminal bonuses will avoid the need to announce lower interim rates than those declared. Speculation about future bonus rates should be avoidable. The concept should be attractive in its own right because it simplifies presentation and should help understanding. On a practical level, it will enable some of the discrepancies created by the present bases to be avoided – which will certainly please a number of clients.

[14] In his maxwellisation representations Ranson has stated that it is completely false to assert that the marketing adjustment was something to be applied at his discretion: the adjustment was implicit within the rates determined by the Board. However, on 27 November 1985 the application of the £2m was remitted to management for consideration: see paragraph 111 above. In his report to the Board of 18 December 1985 Ranson described the first £2m as available to increase the appropriate terminal bonus rates (decided by the Board) depending on conditions in the market place. That was approved. In his report for the Board meeting on 28 January 1987 he recommended that "the £2m released from reserves be utilised to enhance various rates for recurrent single premium business at my discretion". The Board on each occasion approved his recommendations. The maxwellisation representations are rejected.

(iv) The radical changes proposed to the bonus rules for recurrent single premium business, which directors will remember they agreed at the November meeting, effectively comes into force on 1 January 1987. The resultant effect on plan presentation will be significant."

130. The advice was revised in a report presented to the Board on 28 January 1987. The fund had performed better than expected in equities and property. The market had been very buoyant in December and the value of the assets had mirrored that. The overall return was 19%. The dilemma whether to respond to a single day's figures was resolved: if the correct figure had been known in December it would have been used. It was in accordance with practice to use it, and furthermore, the Society's competitors were taking advantage of the sudden increase. No change was proposed in the declared bonus rate or in the interim rate to be incorporated into the terminal bonus. Terminal bonus rates for 1987 could be based on 37%, the same as 1986, taking account of the increase in market value and the £2m market adjustment. That was said to be necessary to keep position in the performance tables:

> "8. ... The standard terminal bonus rate as at 31 December 1985 was 34%. It will be seen that whereas the figures in the December paper pointed to the terminal bonus rates for 1987 on average being lower than those in force during 1986, the position now is that the rates should, on average, be the same. The 34% needs further adjustment to allow for the effect on surplus of the unrecouped (procurement) expenses (in respect of pensions business). This adds a further 3% bringing the total to 37% which again is the figure on which the 1986 rates were based."

Having regard to market conditions, the £2m 'marketing adjustment' was still required to adjust the results at "sensitive" levels. It was said that the effect of the recommendations should be accelerated to 1 January 1987.

131. The actuary commented on these matters in 1987. In a report on the marketing implications of the 1987 bonus declaration placed before the Board on 17 December (see below), he said that reducing the rate for 1987 had involved a risk. "Quite simply, last year, we took a risk and got away with it." The Society had been able to say it had confirmed its interim bonus in the declaration. It had made a decision to alter the format of its press release so that there was no direct comparison with the previous year's declared rates. It was said that most of the press failed to pick it up. Even those who did, got their facts wrong, "which proved, if nothing else that we had successfully "fudged" our press release". It was emphasised that the information had not been misleading; it was intentionally less specific than in the past.

<u>1987 and 'Black Monday'</u>

132. Professor Smith's presidential statement in the 1987 Accounts reflected satisfaction with the year's results. The Society had marked its 225th anniversary by achieving a further significant increase in new business over that of the previous year. 1987 was celebrated accordingly. There had been strong growth in each category of pensions business. The flexibility of the Society's contracts and the absence of penalties, together with the Society's record of consistent and unrivalled past results, would enable it to take full advantage of the significant opportunities presented by new pension legislation. The development of new contracts, of which the highly popular with-profits annuity was said to be a good example, ensured that the portfolio was kept up-to date. He commented on movements in share prices during the year. He commented:

> "As members will be very well aware, movements in share prices in 1987 were even more pronounced than the 'ups and downs' to which I referred last year. Yet it is easy to forget in the wake of 'Black Monday' that, even after the falls, most of the world's equity markets finished the year slightly higher in local currency terms than they began. The flow of income is, of course, basically

unaffected by such sharp fluctuations in capital value, but large price movements provide opportunities for augmenting investment returns and emphasise the importance of timing in asset management. ..."

133. The Society's financial position is summarized in table 3.8. There was total net asset growth of 17%. Premium income (net of reassurances) grew from £398m in 1986 to £500m in 1987 representing total growth for the year of 26%. Premium income included £268m of new business of which £134m was written as single premium business. The investment yield achieved for the year was 6½%. The surplus of income over expenditure for the year was £425m. A total of £125m of capital appreciation was transferred from the investment reserve to the profit and loss account. £45m of that sum was applied to cover the amount of final bonuses paid during the year. £80m was used to augment the actuarially determined surplus, to give a total surplus of £204m, all of which was distributed to policies as declared bonuses. Capital appreciation accrued over the year was £69m. The transfer of £125m drew on the investment reserve balance brought forward from 1986. Since accrued terminal bonus was not provided for, the erosion of the investment reserve was masked. At the year-end, the market had not recovered from 'Black Monday'; the worldwide market collapse in October.[15]

Table 3.8: abridged 1987 balance sheet

	1986 £m	1987 £m
Investments at market value	2,840.1	3,355.6
Current assets	80.7	92.4
Total assets	2,920.8	3,448.0
Current liabilities	35.5	61.8
Net assets	**2,885.3**	**3,386.2**
Long-term business fund	2,305.1	2,862.4
Investment reserve	580.2	523.8
Total fund value	**2,885.3**	**3,386.2**
Investment reserves:		
- Opening position	435.8	580.2
- Movement	259.4	68.6
- Capital appreciation treated as surplus	(115.0)	(125.0)
- Closing position	**580.2**	**523.8**

134. The Board papers reflect disquiet over the year. Markets were volatile. 'Black Monday' had disturbed temperament. Investment advice was to show a bias in favour of fixed interest investments. In relation to bonus strategy, much of the advice tendered to the Board used the same language and followed the same structure as previous years. Existing levels of bonus would require "support". Capital appreciation would have to be appropriated. The estimate was £100m, which was said to be well within the nominal value of the existing investment reserve.

135. In the light of the general financial environment, the need to move towards a lower level of reversionary bonus declarations was acknowledged. It was thought that solvency margins were likely to become more testing. The device of the 'marketing adjustment' was adopted to allow the actuary discretion to increase actual payments, where doing so would create marketing advantage. In the event, the year ended with a late flourish in the equity markets. There was an almost tangible sense of relief in the actuary's report to the Board on 28 January 1987. But market volatility returned as a feature of 1987. The interaction of investment and

[15] See financial tables, table B.3.

bonus policies was discussed in the actuary's 25 March 1987 paper on investment considerations. He advised that regulatory constraints imposed under the Insurance Companies Act, which related to the identification of admissible assets and matching requirements, affected the Society. If one assumed a 65% renewal pattern of recurrent single premium business and a ten-year duration on average, there would be a mismatched position. He advised that the position could be restored by considering a thirteen-year period of average duration. The average duration for business had caused concern in 1986. The average duration of in-force business was fifteen years. But the matched position was weaker than before. Any mismatching required reserves that would reduce the amount available for solvency. He said that no mismatching reserve was required at 1985, but the Board could not rely on that continuing. Any significant mismatching in 1987 would require mismatching reserves. There was no need to "select" fixed interest stocks. But there should be a bias towards sterling fixed interest investments, all other investment considerations being equal, to build up matched investments for non-profit liabilities.

136. The Board was reminded that the current strategy regarding declared bonuses was to reduce them systematically to levels consistent with current interest rates. There would continue to be a requirement to support revenue by appropriations of capital appreciation if existing bonus rates were maintained. As quoted below the implications for investment were that the greater the proportion of new money invested in fixed interest securities at current market rates, the greater the certain call on the appreciation of existing assets to make up the shortfall in earnings. On the other hand, although investment of new money in equities would have the potential for higher earnings, the Board were advised that if those did not accrue within the appropriate timescale, the call on the existing investment reserve would be that much greater. At current yields a declaration at the year-end based on a rate of £7½% would create a shortfall of £60m. £40m would be required for terminal bonus payments. Writing up of at least £100m would be required. Changes in interest rates would require revision of the forecast. The paper repeated the previous year's view that stability of surplus was not the priority it had been because of the policy of moving towards lower declarations.

137. The report stated:

> "17. In considering stability of surplus, the argument advanced in the past has been that since it is necessary for bonus stability to avoid severe fluctuations in surplus, too great a dependence upon capital appreciation in the assets is undesirable, because of the volatility of market values. On occasions (e.g. during the 1970's) this has led to a recommendation that a significant proportion of new money be invested in fixed interest securities. Such a recommendation has usually been associated with the availability of interest rates at least high enough to support current bonus rates and hence the risks associated with equity type investments could be avoided.
>
> 18. As discussed in papers to the Board at the end of 1986, the current strategy regarding bonuses is to reduce them in a systematic way to levels consistent with current interest rates from the relatively high levels associated with the interest rate climate persisting up to 1982. If interest rates persist at the 10%/11% level, then bonuses based on about £6.50% for pensions business will be supportable on interest rate considerations alone. To the extent that the fund earns less than 10%/11%, transfer from capital will be required to make up the shortfall. This was our well established practice in the 1970s and early 1980s. The last declared rate was £8.50%, however, and we discussed a rate for 1987 of £7.50%. Clearly, this implies support from capital not only sufficient to make up the income from a mixed portfolio to what it might have been had it been invested wholly in fixed interest securities but also sufficient to provide the earnings in excess of current interest rates.

> 19. The implications of the bonus strategy for 1987 for investment are that the greater the proportion of new money invested in fixed interest securities at current interest rates, the greater the certain call on the appreciation in the existing assets to make up the shortfall in earnings. On the other hand, although investment of new money in equities would have the potential for higher earnings, if those did not accrue within the appropriate timescale, the call on the existing investment reserve would be that much greater.
>
> 20. The running yield on the fund (excluding the assets held against unit linked business) is estimated to be about 8.4% after the writing up of assets following the declaration. If we were to declare at the end of the year at rates based on £7.50% for pensions business, which requires earnings of about 11½%, the writing up required to make up the shortfall in investment income would be about £60m, assuming that the fund earns about 8.4% on average over the year through revenue. Terminal bonuses of about £40m in aggregate are expected to be paid during 1987. Hence, writing up of at least £100m, is likely to be required at the year end."

Investment in fixed interest securities at current rates would not support bonuses at current levels: the Board was pointed in the direction of increased equity investment and increased risk.

Introduction of the personal pension

138. On 24 June 1987 the actuary presented a paper on the new personal pension then expected to be introduced from 4 January 1988. The paper did not identify features of existing business that would be departed from. It stated, however:

> "A strategy document was formulated by the end of March and agreed by the senior management team. A major component of the strategy was to make use of existing products, as much as possible, in order to minimise the changes needed to existing administrative and computer systems, and to enable the Society to exhibit an unbroken track record of past performance."

The new form of business was to be presented as aligned with the superseded retirement annuity contract to ensure that previous performance records could be used with reference to the new contract. In management records it was noted that premium bases would be the same as for retirement annuity business. In the present context the decision was reflected in distribution practice going forward.

139. In relation to bonus policy, this was a momentous, and ultimately disastrous, decision. Had the Society acknowledged liability to meet the annuity guarantees, it would necessarily have identified a difference in the benefits provided by the former and the new contract forms. For equal premiums, the new personal pensions offered lower levels of contractual benefits. On conventional actuarial practice the Board might have concluded that a higher level of bonus was appropriate for the new business accordingly. The means of calculating the difference were available in the developing techniques of stochastic modelling. The Society might have avoided the *Hyman* problem at the outset.

140. There would undoubtedly have been marketing implications. Policyholders might have preferred to switch to the new forms, the marketing push of 1987 and 1988 could have been abortive. The Board might have been forced to propose a new with-profits fund, closing the old fund to new business. But adopting a market-driven policy, against the background of the management decision in 1982-3 to "solve" any emerging problem by discriminating at maturity, established the bonus policies and practices that were thereafter to develop, and to lead to the confrontation of 1997.

The 1987 declaration

141. The subject of the 1987 declaration arose in the actuary's preliminary report presented on 28 October 1987. The recital of the position in 1986 included the statement that

> "3. A crucial part of the considerations related to the long-term implications of the different choices available regarding the level of declared rates. In particular, the effect of maintaining for too long a bonus rate which cannot be supported from current earnings was investigated..."

The advice followed the lines of the equivalent report of the previous year. Illustrations were provided that traced the effects of practice over the four years 1985 to 1988. The investment reserve was predicted to fall in cash terms and, more dramatically, as a percentage of liabilities. It was said that solvency would increase in cash terms, but that the fall in equity and property values required to uncover the solvency margin would fall dramatically. A fall of only 10% in those values would uncover the solvency margin. It was said that the Society could not allow itself to deteriorate to the projected 1988 position. The Board was advised that declared rates would have to fall. It was recorded that there would be undesirable marketing implications.

142. The Board was advised that there were choices to be made at the declaration. Bonus rates could be maintained, reduced or increased. Various factors were discussed. A declared rate of £8½% and a return of 20% would leave the Society in about the same position as at 1986. The long-term implications for solvency cover were set out. The projections overall reinforced the view of risk. There had been equity gains early in the year. Maintaining a high, declared rate because of equity returns was said to be effectively a short-term option. The effect of a good year was quickly diluted by poor years:

> "21. The outperformance of equities in recent years has led to an increasing proportion of equity-type investments in the 'with-profits fund'. That shift has occurred at a faster rate than the movement in the balance between 'consolidated' and 'unconsolidated' benefits in policy proceeds i.e. between declared and final bonuses. Accordingly, the proportion of guaranteed liabilities backed by fixed interest assets has declined. With the continuing strength of equity markets and the recent levels of the Investment Reserve, the investment position has not been such as to impose constraints on investment strategy. In the event of adverse conditions that position would need reappraisal since the security of the guaranteed benefits could come under some pressure."

143. The report set out projected values for 1988 for the theoretical, smoothed and actual proceeds of hypothetical policies of specified durations. The 'theoretical' values were said to represent 'asset shares'. Smoothing modified those results to ensure a steady progression of results from duration to duration. The 'actual' column reflected the rates announced. The term 'asset share' was defined as "the share which each policy leaving the fund has in the fund". The position was developed for the Board meeting on 25 November in a further "scene-setting" exercise. It was said that the October paper had been overtaken by events. There had been significant movements in the market. The paper set out comparative data to illustrate the volatility of the situation. The position was said to be less comfortable than earlier in the year, and, unless markets improved, certainly a less comfortable position than at the end of 1986:

> "An important technical consideration is that we have to publish a valuation as at 31 December 1987 using bases laid down in regulations and taking into account the market value of the assets on that date. Part of the requirements is to demonstrate that assets exceed liabilities by the so called solvency margin, which is itself calculated from bases laid down in regulations. The purpose of the exercise is to satisfy the Department of Trade in their supervisory capacity.
>
> It is almost inconceivable that we could not meet the supervisors' minimum requirements almost regardless of market conditions at the time. The point needs to be made, however, that if the Department of Trade felt that the Society were 'weak' or acting imprudently they might take an interest. In the

> extreme, such interest could require an office to stop taking new business for example."

There was said to be no point in developing the discussion. But there were circumstances which, in combination, could make it impossible for the Society to achieve its objectives. In certain circumstances too long a delay in taking remedial action could potentially jeopardise the solvency of the business and unpalatable decisions could be forced on the Society.

144. The report set out the risks for the fund at the levels of return of 20% and 15%. At around 15% and below, it was said that the risks would become significant and a reduction in declared rates might be unavoidable. The report developed the projection of 'asset shares' on varying hypotheses for 1988 and later years. The crude values indicated that if the fund earned only 5% at market values in 1987 'asset shares' in 1988 should theoretically be cut by 5%. If the fund earned 10% the 'asset shares' could be sustained for policies of longer duration. The falling away of amounts at shorter durations was inevitable. At this stage the definition of 'asset shares' continued to be expressed in terms of the fund at policy maturity.

145. The paper was re-submitted along with a further paper for the board meeting on 16 December. The actuary still avoided firm recommendations. There was a résumé of discussions to date. In relation to projected policy proceeds in 1988 the report contained the following discussion.

> "3. In order to make progress, it might be helpful to develop some fairly firm views about the level of policy proceeds in 1988. As is customary, most of the discussion will be in respect of the pensions contracts. ...
>
> 4. The paper to the November Board contained some figures .. indicating 'asset shares' on certain assumptions for 1988 and a few years beyond relative to 1987. By 'asset share' is meant the accumulation of premiums at the actual return earned on the assets at market value year by year. Those figures indicated that if the fund earned 10% /11% in 1987 and each year for the next three or four, policy proceeds for durations of 15 years and upwards could at least be maintained.
>
> 5. The figures also indicated that on those assumptions, policy proceeds at duration 10 should fall by some 7% in 1988 and progressively thereafter. At durations below 10, a 10% reduction was indicated, with subsequent results falling fairly quickly. ..
>
> 7. The with-profits system is all about averaging of experience over time and to some extent over generations. The averaging over generations, however, has to be reasonable and essentially for smoothing purposes from one year's results to another's. For example, to attempt to maintain short term results at current levels would inevitably introduce severe distortions and inequities. On a practical point, since the weight of payments out are currently at those shorter durations, the drain on the funds could become onerous and potentially lead to a faster decline of all policy proceeds than might otherwise have been the case.
>
> 8. In my view, it would not be inappropriate to take credit for earnings in the region of 10% for the year. This is based partly on our usual approach to averaging performance over 3-4 years in order to iron out fluctuations, and partly on the possible need to go a little further in the current special circumstances and anticipate a certain level of future earnings. If, as appears likely, earnings are below 10%, by taking 10% on this occasion we are anticipating that in the next year or two the current 'over statement' will be recouped. If the timescale is reasonably short, such an approach is part of the traditional with-profits system. If, in the event, earnings do not rise, then any cut back in results in future will come a little earlier than would otherwise have been the case. If earnings turn out to be higher than 10% because of a

> last minute turn up in the market, my current view is that earnings above 10% should not be utilised because of the recent volatility of prices.
>
> 9. The rationale behind suggesting a deemed return of 10% in 1987 is to maintain policy proceeds for durations of 15 years and upwards in 1988 broadly unchanged from 1987. Although a bonus declaration is essentially to deal with existing business, we cannot overlook the implications in the market place. ... On this occasion, my current view is that it would be appropriate for marketing reasons to maintain the 1988 10 year benefit payments at their 1987 level by further support, but that we should let the 5 year benefits fall to a more natural level. By cutting back support at the very short durations, we shall find the overall support less onerous."

146. The Board now had an additional definition of 'asset share':

> "By 'asset share' is meant the accumulation of premiums at the actual return earned on the assets at market value year by year."

Subject to smoothing, the Board would have understood at this stage at latest, that on the managed fund approach the policyholder would be paid at maturity a sum that accumulated his contributions, net of expenses, at the actual rate of earnings on the fund disregarding guarantees. The idea was essentially objective in character, always subject to the operation of whatever smoothing policy was in operation. Premiums, net of expenses, were finite values. The returns earned on assets at market value were computed regularly and were readily identified. The definition made no provision for extraneous factors. A definition of the smoothing parameters applicable from time to time would have been essential for a full understanding of practice. There is no evidence that this was ever sought or provided.

147. The December report discussed declared bonus. It was said that a higher proportion of the sum declared would require transfer from capital appreciation than previously thought. Hence the declaration had practical implications. There was a dilemma however. Higher guaranteed benefits meant less freedom of action. For control of the business, a lower declared rate was indicated. But if there were a backlash in the market place and new business plans were invalidated, that could involve loss of control. The report stated:

> "My major concern is for the actuarial management of the office in the longer term. That can be prejudiced by looking for short term advantage or, rather, avoiding short term disadvantage. A life office is a fairly fragile creation and, as has been illustrated by the failure of UKPI last year and the recent difficulties experienced by London Life, once it begins to get out of control, room for manoeuvre is limited and, almost certainly, becomes progressively so."

148. However, the need to maintain levels of bonus was reinforced by a marketing report presented to the same Board. It was said that the Society now faced a different situation from 1986. The incorporation of the interim bonus into the final bonus meant that any reduction in declared rates would be highlighted as a real cut. Bonus declarations would be subject to intense scrutiny. It was said that the trade press was hostile to the Society. London Life's difficulties were unhelpful. In the highly charged atmosphere of 1988 it was said that any reduction in bonus would be used against the Society "aggressively and comprehensively" by competitors. There were risks of de-motivation of the field force, loss of support from consultants, disenchantment of policyholders, adverse press reaction and weakening of competitive position.

149. It was said that the Society occupied the middle ground in terms of strength. If immediate competitors were stronger and could maintain reversionary bonuses and maintain or even increase total payments, they would gain a considerable competitive advantage. There had to be a convincing story, one had to avoid a low profile, and tell everyone the story. The Society should try to make a virtue out of necessity. Maintaining bonus would be the preferred course. If bonus had to be reduced, it should be presented as part of a phased programme, keeping options

open. The logic of that did not have much human appeal. It would be better to present it as keeping a proper relationship between declared bonuses and fixed interest yields. Weight could be given to terminal bonus philosophy and total benefits. But a reduction in reversionary bonuses would carry real risks.

150. The marketing paper lacked the measured tones of actuarial reports of the period. Prudence was acknowledged in passing. In a further paper for the Board on 27 January 1988, the actuary recommended that if the 1988 levels were to be held at the preceding year's values, certain technical adjustments were required for the first three months of the year. It appeared that the fund would earn 9% due to late market recoveries, and it was said that there was no need to modify the approach previously developed. The Society would need to use some of the investment reserves brought forward. This would make it look weaker. There would be a loss of solvency cover. But the risk could be taken. A rate of 7½% would be recommended.

151. On 10 February 1988, the final report for the year recommended a rate of 7½%. A 'first call' of £125m was required. The revised balance sheet value of the assets was £2.9 billion. The investment reserve was £524m. In valuing liabilities, the same bases as at 1986 had been used, except that £65m had been stripped from reserves to reflect the change in bonus rules applying to single premium business and to weaken the valuation in the case of policies involving multiple payments within the year. The liabilities were valued at £2.7 billion and the surplus was £200m. After the cost of bonus at the recommended rates, a balance of £1.6m remained to be carried forward.

152. In relation to terminal bonuses, it was recommended that rates be fixed to give broadly unchanged proceeds at ten years and above with lower proceeds at shorter durations. Some support would be required. The cost was likely to be about £6m. The source of the £6m was not specified. "Support" had become a settled actuarial euphemism to describe the allocation of bonus for which the Society did not have the necessary funds. 1987 was characterised by anxiety over market position and the risks posed by a reduction in bonus rates. The bonus policy adopted reflected the need for "support" at all levels, resulting in lower solvency margins, and over-allocation of bonus.

153. The Society had experienced a poor year on the market achieving an investment return of 9% including an average income yield of 6½%. There was an increase in investment values of £524m, the increase including an estimated £69m of capital appreciation. Market gilt rates continued to decline, with yields falling from 10% to 9½%. This put the Society under additional pressure to cut reversionary bonuses, which they did from a level of 8½% to 7½%. Actual earnings were insufficient to meet the total required surplus of 11½%, comprising the 3½% roll-up rate of investment return, a reversionary bonus of 7½% and a terminal bonus of ½%. There was an income shortfall of 5%. This shortfall was met by calls on capital appreciation of £125m (£69m of which was generated in the current year). The result of maintaining high levels of bonus was a total difference of minus 2½% arising between actual returns and the allocation.

154. By this stage, the Society had eroded the strength of the 1982 balance sheet by progressively cutting back on the reserve for future reversionary bonus until it was eliminated, they had used the previously un-attributed accounting adjustment from 1982 of £4m, and finally, had explicitly, at least in 1987, made a bonus allocation in excess of available returns.

The 1988 Declaration

155. Professor Smith's presidential statement in the 1988 Accounts was enthusiastic. The Society had taken the opportunities for growth presented by the changes in pension legislation. Growth targets set for 1991 had been exceeded. He reported that the pattern of final bonus allocations had altered to favour policies of longer duration. He emphasised the Society's pre-eminence as a provider of pensions policies. The Society disclosed for the first time its total return on fund at market

value, which was 14.6%. His comments reflected the fact that 1988 had been a better year overall. There had been a marketing drive to push sales of retirement annuity contracts before they were superseded. There were successful sales of the new product.

156. The Society's financial position is summarised in table 3.8. Net asset growth of 23% (1987: 17%) was achieved. Premium income (net of reassurances) grew from £500m in 1987 to £622m in 1988 representing total growth for the year of 24%. Premium income included £377m relating to new business of which £190m was written as single premium business[16]. Investment income for the year was £237m. The investment yield achieved for the year was 6.4%. There was substantial capital appreciation reflected in the investment reserve growth of £261m. The surplus of income over expenditure for the year was £499m, which represented "net new money" available for investment. A total of £167m of capital appreciation was transferred from the investment reserve to the profit and loss account. £75m of this transfer covered the amount of final bonuses paid during the year, while the remaining £92m was used to augment actuarially determined surplus to give a total surplus of £185m, all of which was distributed to policies as declared bonus.

Table 3.8: abridged 1988 balance sheet

	1987 £m	1988 £m
Investments at market value	3,355.6	4,108.9
Current assets	92.4	123.4
Total assets	3,448.0	4,232.3
Current liabilities	61.8	69.3
Net assets	**3,386.2**	**4,163.0**
Long-term business fund	2,862.4	3,544.8
Investment reserve	523.8	618.2
Total fund value	**3,386.2**	**4,163.0**
Investment reserves:		
- Opening position	580.2	523.8
- Movement	68.6	261.4
- Capital appreciation treated as surplus	(125.0)	(167.0)
- Closing position	**523.8**	**618.2**

157. However, the year began with a degree of pessimism. By the date of the investment appraisal in March the markets had shown some growth. But projections pointed to a need for a further cut in reversionary bonus unless fund performance kept up. New business strain associated with the business expansion programme was a growing factor. Bonus policy was first referred to in the investment strategy report in March. The paper repeated much of the previous year's material. It was reported that the securities required for matching purposes could be built up without detracting from the overall investment potential. Stability of surplus was said not to be of prime concern. It was suggested that stability in declared bonus rates might become less of a preoccupation in the industry. The actuary presented a preliminary report on 1988 to the Board at a meeting on 26 October. Having reviewed the past, the report stated:

> "4. The decisions to cut bonuses at the 1986 and 1987 declarations were not easy to take and reflected a determination to move down to what was seen as an almost inevitable ultimate level in a systematic manner and at a speed which demonstrated our control over the business. At both bonus declarations

[16] See financial tables, tables B.3 and C.3.

higher bonuses might have been declared but it was agreed that it was desirable from the viewpoint of good financial management to declare at lower rates. At no declaration in recent years has it been impossible to declare at the rate desired although a repeat of the poor market performance of 1987 might begin to force that issue.

5. For a number of reasons, the position at the forthcoming declaration may be less clear cut than previously and the course of action may be less obvious. ..."

The report characterised the practice of previous years accurately: bonus had been declared at the level desired. The desired level had been the driver of policy rather than the product of the valuation.

158. Investment conditions were said to show growth. The assumption of a 10% interest rate climate pointed to a declaration at 6½%. It was said that a further reduction of rates would be justified to achieve that. Earlier in the year interest rates had fallen and long-term rates were still closer to 9%. If these conditions persisted a reduction to 6½% at some stage was likely to be necessary. But it was said that if fund performance kept up, it might be possible to defer the decision. The actuary commented on the market's preoccupation with 'strength'. He said that much of the comment was misguided. But apparently declining strength could cause adverse comment. The directors "need to be careful not to leave ourselves vulnerable to the charge that our growth is in danger of outstripping our financial resources." He said that the Society was in the middle rank in terms of 'strength'. It should try to avoid further reduction in its position.

159. The cost of meeting bonus rates of 7½% and 6½% was set out. Final bonus payments were £70m and financial strain £25m. If overall earnings were 15%, 7½% could be declared, with a transfer of £185m from investment reserves, and strength would be maintained. The marketing implications of a reduction in declared bonus were discussed. There was a discussion of the procuration costs of business and the origins of new business strain. The accumulated strain at 31 December 1987 was £100m. By year's end it could have risen, with interest, to £130m. It had to be covered by a call on the investment reserve. It was said that if the strains became too great, the drain on capital would become insupportable and new business activity would have to be cut back. Ranson believed that few other offices could sustain the Society's rate of growth. The Society's model of financial management was unique, but there was a very fine balance.

160. But by November equity performance had improved and the advice was that the planned reduction in bonus rates could be postponed. It was noted that if other offices reduced their rates, however, the Board should give careful consideration to following suit. The report for the meeting of 23 November 1988 contained an account of previous experience. Ranson said that equity performance had enabled the Society to postpone a planned reduction in declared rates until 1986. Reduced rates had been adopted in 1986 and 1987, and market movements had vindicated that course. In looking forward, the actuary said:

"6. Whilst a continuation of the planned reduction in declared bonus rates would be consistent with our overall strategy, I do not believe that on the current occasion we can ignore the market place.

8. I have come to the fairly firm view that we need to be very conscious of market pressures at this stage in our development and should be willing to be market driven provided we can afford it. In other words, if the financial position at the year end allows us to repeat the declaration at the level of last year without weakening the balance sheet position, then there are good reasons for doing so. Having got the declared rates down to their current level, we should be prepared to consider pausing before continuing the planned move to the lower bonus climate. If, however, a number of leading offices do cut rates, then I think that we should give careful consideration to the

> question of reducing our own, thereby taking the opportunity to strengthen the balance sheet position."

Ranson again anticipated close scrutiny of results. There had already been adverse comments on the relative strength of the Society. Most comment would revolve around actual rates declared and the balance sheet position.

161. A further report was submitted on 21 December. The purpose was to move towards an assessment of the possible total policy proceeds for policies leaving the fund in 1989. In discussing money values, the report introduced some novel ideas. The report noted that for the past three years, the Society had adopted a deliberate policy of supporting policy proceeds above their natural levels for durations of ten years or more. It was said that there was a limit, however, and 1988 might be a year when it might strain the resilience of the system too much to resist a cut in actual proceeds for policies leaving the fund. The report contained a statement of the managed fund approach in its starkest form:

> "In its most basic form, at any point of time the unconsolidated surplus in the managed fund (broadly equivalent to what we would term the investment reserve) would simply represent all the premiums accumulated to date at the earned rate of return less the surplus already consolidated as guaranteed benefits or declared bonuses. Each policyholder's share of that unconsolidated surplus would be calculated on a similar basis."

Smoothing and averaging were said to be necessary. The managed fund concept would have been the equivalent of a unit-linked operation without those elements. In fact, the Society's practice had involved over-distribution:

> "For the past three years or so we have adopted a deliberate policy of supporting policy proceeds above their natural levels for durations round about ten years or so.. There are limits to the amount of averaging which is possible and fair."

In my view, a smoothing policy would have defined those limits as a guide to decision making. The analysis of the Society's practice from 1982 does not demonstrate 'averaging' in any sense: it demonstrates progressive 'support' of levels of bonus, first from previously accumulated reserves, and then from current capital. One would understand that there had to be limits to that process. But it could not be described as 'averaging'.

162. A further report was submitted on 25 January 1989. The actuary concluded that earnings would be around 14½% at market values. He said that that would enable the Society to declare rates at the same levels as the previous year. Terminal bonus levels should be set at broadly unchanged rates for fifteen years' duration with increases above that term and reductions below. The reasoning in the report showed little change. The Society was advised to delay implementation of its intended policy of moving towards a lower declared bonus climate because investment returns were relatively high. The emphasis continued to shift towards total returns. The main change was that the ten-year duration was no longer that at which returns were held.

163. Although the actuary referred to the "support" of policy proceeds over previous years, he did not spell out the level of support implied in his advice for the current year. He wrote:

> "At each valuation we assess the current value of every policy, including the unconsolidated earnings or final bonus then attributable. This is part of the exercise of assessing and setting final bonus rates. It should be noted that because we average out investment earnings and hence average market values, there are occasions when the aggregate of the current policy values, or shares of each policy in the fund, exceed the current market value of the fund and occasions when they fall short. The purpose of apportioning the as yet unconsolidated earnings in the fund across all policies is to ensure equity

> between policies leaving the fund in the near future and those remaining in the fund."

The comment described smoothing around a bare equilibrium defined by the fund at market value and aggregate policy values. The purpose explained would have made sense of the allocation of unconsolidated surplus, had it existed. The inquiry has not uncovered documentary evidence to suggest that the Board, as such, were instructed in the implications of sustained over-distribution for continuing policyholders.

164. By 1988, there had been a progressive shift in policy towards relative reductions in reversionary bonuses and increases in terminal bonuses. This was represented to policyholders as being related to investment policy. Sherlock wrote to policyholders explaining the position in relation to the bonus declared at 31 December 1987 in those terms.

Summary

165. 1989 was to be a year of material change of direction. Before turning to the new approach revealed to the actuarial profession at the start of 1989 in the paper, *With Profits Without Mystery*, and to the volatile events of the 1990s, it is appropriate to rehearse in summary some of the critical developments over the period discussed so far. Between 1962 and 1972, the Society had a conservative and relatively unsophisticated approach to bonus. All bonuses, with the exception of the final annuity bonus, were declared in reversionary form, and capital appreciation was used in supplement of revenue sparingly: not more than one-tenth of the appreciation at any time was considered available for distribution.

166. Terminal bonus was introduced in 1973 as a marginal adjustment of total allocations at maturity. Ranson, with the support of Sherlock developed the three-call system of reserving that provided a rational basis for the appropriation of capital appreciation. The system was conservative, making full and prudent provision for future reversionary bonuses during the projected period of deficiency of actual investment returns as against the benchmark yield on gilts. The terminal bonus 'fund' was the balance of capital appreciation, initially off-balance sheet, but in and after 1982 shown in the investment reserve. Allocation of the investment reserve to terminal bonus was made on a three-year rolling average.

167. The adverse market conditions of 1973 and 1974 undermined the assumptions on which the three-call system had been based. The system was suspended. The application envisaged became possible in a realistic sense only in the period 1979 to 1982. But by then it was appreciated that, in the interest rate climate of the period, strict adherence to the benchmark would generate unacceptably high reversionary bonuses, and second call reserves, squeezing terminal bonus and threatening it at critical times. Competitive forces became a material factor, and the second call was eroded and finally abandoned. The terminal bonus element, the investment reserve, was inflated accordingly, and the Society changed the balance of allocations progressively towards terminal bonus, reducing the proportion of surplus allocated to declared bonus. Response to market conditions inhibited a declared policy of moving towards lower declared rates. But available resources were increasingly directed towards increasing terminal bonus.

168. In 1986 and 1987, the sums available in investment reserve were supplemented by the appropriation of general reserves amounting to £4m, to massage total payouts on pensions business at sensitive durations, taking the Society into a position of over-distribution. Adverse market conditions aggravated the position, and an excess of aggregate policy values over available assets continued into 1988. And as I will describe in the next chapter, even in 1989 when there was a good return, the Society deliberately distributed a high proportion of the available return for market-related reasons, and entered the 1990s with a negative estate accordingly.

169. Over this period there were references to smoothing as an inherent characteristic of with-profits business. There was at no time a statement of the Society's smoothing policy. There was no specification of smoothing parameters, as regards a target line of equilibrium, deviation above or below any such line, target durations of any smoothing cycle or any other factor. The description of the position in the late 1980s as a point on the smoothing cycle appears to have had no basis in reality. It would have been possible to consider the restoration of reserves between 1976 and 1982 as part of a smoothing process if the parameters had been defined. From 1982 until the end of the decade the Society had progressively weakened its reserves until a negative position had become established where policy values intimated in illustrations and on pay-out exceeded available assets. If there had been a smoothing cycle, it was without defined limits of value, and it was without defined limits of time.

CHAPTER 4: THE MANAGED FUND APPROACH, 1989-96

With Profits Without Mystery

1. On 20 March 1989 Roy Ranson and Chris Headdon presented a paper to the Institute of Actuaries entitled *With Profits Without Mystery*, in which they set out the 'philosophy' of the office approach to with-profits business in the modern environment.

2. The paper identified the unique features of with-profits as an investment medium: smoothing and increasing guarantees. It was said that with-profits business was attractive for offices, since it provided a source of capital for expansion of the office and for the development of subsidiary businesses, given the degree of freedom in the investment of the with-profits fund. The authors considered that the policyholder made a contribution to the office's funding requirements for the development of the business by providing capital for financing new business. They described the 'managed fund' concept, and the objective that policyholders should ultimately receive benefits that reflected the value of the assets in the fund attributable to the investment, their 'asset share', when the policy benefits became payable. The policyholders' investment in developing the business would be rewarded through the mechanism of terminal bonus.

3. New business was said to be desirable for the existing members of a fund because it helped maintain the proportion of guaranteed benefits in the business as a whole at a level that did not unduly constrain investment freedom. It would appear that that could only be the case if the new business was valued at less than face value, so as to release surplus from the commencement of the contract. Otherwise the effect of writing new business would have been to increase the proportion of guaranteed benefits in the fund as a whole.

4. The paper stated that the concept of the managed fund was an explicit expression of an attitude that had prevailed in Equitable over many years. The business belonged to the current generation of with-profit policyholders. When they left they should take 'full value' from the fund. The Society did not believe in the concept of an 'estate'. However, this bold statement was an inaccurate representation of the position. As a matter of policy, the Society had explicitly held an estate until 1972. That estate had been exhausted between 1973 and 1976, when policyholders had been given benefits earned by their predecessors. The Society had then deliberately re-built a significant estate by 1982 by, in the terms of the paper, withholding benefits from current policyholders, since when a degree of over-distribution had developed. Thus it was only in the middle to late 1980s that there came to be a positive assertion of a full distribution policy, when the Society had abandoned the second call on capital appreciation that had been designed to safeguard future reversionary bonuses, and related the terminal bonus allotment to the whole of the investment reserve.

5. Here, therefore, was a further part of the Equitable mythology. The paper proceeded to assert that the managed fund 'concept' had been used internally for years, but had only recently been used in communicating with clients. The expression 'policy annuity value' had been introduced in 1979 in the specific context of the introduction of the open market option. 'Present value' presentation to members was introduced at the 31 December 1987 valuation. The paper stated that the managed-fund concept allowed the surplus emerging in a given year to reflect the Society's current financial experience.

6. In relation to bonus distribution, the paper stated:

> "3.2.2. ... The key consideration for bonus distribution policy is the most appropriate way of passing on their 'asset shares' to policyholders leaving the fund. ...
>
> 3.2.4.The question of averaging and smoothing of performance is crucial.

> 3.2.5.We... believe that, in modern conditions, with-profits policyholders expect to achieve total policy proceeds broadly commensurate with those under a linked managed fund contract ...
>
> 3.2.6.If one accepts that the policyholder's key concern is the total proceeds achieved, then the matter of how those proceeds are made up between declared and final bonus elements should be of secondary importance...
>
> 3.2.9.If the decision as to the level of declared bonus rates is viewed as really being a decision as to the level of earnings which should be consolidated, then the choice of the precise level of declared rates is clearly arbitrary... Naturally, such choice has to have regard to the marketing implications of any decision."

These views, the paper said, had been communicated to the Board. They came close to equating with-profits and linked contracts in relation to the dependence of policy proceeds on underlying assets, subject to some, undefined, degree of smoothing. It was, perhaps, not surprising that some critical comment fastened on the difficulty of operating the system without free assets. In a situation of assets deficiency it appeared to suggest that the maturing policy should fall in value. But that was unlikely to be a situation in which it was irrelevant to the policyholder how bonus had been split between guaranteed and non-guaranteed elements.

7. In relation to terminal bonus, the objective of the Society's practice was said to be to lift the guaranteed benefits and declared bonuses to the appropriate asset share[1]. The current method of calculation was set out. The paper explained:

> "3.2.16. It should be noted that all of the with-profits reserves are brought into these calculations. In other words, the final bonus rates are not just assessed in respect of business leaving the fund but in respect of all of the with-profits business in force at the date of valuation. There is a further point that solvency margins are set up from the unconsolidated surplus and, by implication, the outgoing policyholder takes his contribution to those margins with him."

According to the authors, therefore, final bonus was assessed in respect of all with-profits business, in the context of the with-profits reserves, for current and for maturing business. The implication was that the aggregate of the final bonuses accrued at any reference date was related to the unconsolidated surplus. The policyholder at maturity took his share of the long-term fund, including the unconsolidated element that had been assessed for and allocated among all policyholders. As we have seen and will see, that was not the reality at the end of 1989, or at any time thereafter. It had not been the reality for about three years before 1989.

8. The paper received a mixed response from those attending the session in London at the Institute[2]. The idea of an estate was not universally repugnant. Criticism was restrained. A number of speakers agreed with the approach adopted. The comments made suggested that many in the audience had a clear understanding of the Society's financial position and policy stance. One contributor indicated that the Society's approach involved risks and that the policyholders should know what they were. One thought the Equitable model was formless. Another, perhaps somewhat tongue-in-cheek, assumed that the authors had described a principled approach that differed from general practice. He said:

> "... the average actuary... begins with the bonus he wants to declare... then he works out actual costs; then he manipulates the surplus... to get the answer; and then pays a bonus that is highly inequitable..."

9. The authors were warned that failure to achieve balance would lead to insolvency in the long run. It was said that they had not explained their smoothing

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[1] Paragraph 3.2.15.

[2] Which was presided over by Roger Corley.

practices. Ronald Skerman (whose role in relation to the concept of policyholders' reasonable expectations will be discussed later) said that he thought the bonus strategy put forward was entirely sound. On the other hand, he was worried about smoothing and the use of the investment reserve. He was also a proponent of strength. He said that an office without strength would face competitive pressures sooner or later.

10. A further contributor said that the advantages of the managed fund approach were clear, and he identified the clarity of presentation of bonus, the link between future bonuses and investment return and the ability to reduce new business strain as factors. But he identified pitfalls. There would be a need to consolidate a large proportion of capital appreciation. Most offices had an estate. The arguments against it were not compelling. He thought that Equitable had only been able to do without an estate because of exceptional growth in equity values.

11. Given the professional reluctance of actuaries to indulge in mutual criticism, it would be difficult to characterise the bulk of the contributions as other than critical and even hostile. If the contributors were typical, the Society's practice was exceptional, with few supporters in the audience. If it was not unique, it was representative of the practice of a small minority of offices. But the paper ensured that the profession as a whole was well informed and had been put on notice of the characteristics of the Society's practice.

Presentation to the Board

12. Two days after the initial presentation of *With Profits Without Mystery*, Ranson presented a report on investment considerations to the Board. It contained a number of depressingly familiar paragraphs, considering the heat of professional debate at the time. There was no change in approach from the equivalent paper in the previous year. The Board was advised that it was not necessary to be over-concerned about precise matching of assets and liabilities. Regulatory solvency margins would be well covered. The theoretical risk that mismatching reserves would be necessary or that the office valuation base would need to be strengthened was considered. It was emphasised that there was nothing inherently "wrong" or "weak" about needing to set up mismatching reserves: many offices did so. The recommendations were consistent with the previous year. The comments on stability of surplus remained broadly the same. The paper did not point out that the significance of mismatching reserves might depend on the size of an office's free estate, as clearly it might. An office with substantial free assets might be less constrained in its investment policy, even if it did have to set up mismatching reserves, because of its overall strength.

13. In relation to bonus, the autumn discussion paper for the meeting of the Board on 22 November stated that it was concerned in part with a proposed further development and simplification of the bonus system, and preliminary comments on 1989. The new system was to come to have significant PRE implications. These will be discussed in a later chapter, but for present purposes it is important to note the basis on which it was introduced. The paper contained a general discussion of with-profits business in familiar form. The Society's approach was said to be to smooth the profits in excess of the guarantees and pass them on as bonuses. The mechanics were said to have obscured the simplicity of the system: it was time to make it more transparent.

14. The approach to bonus was discussed in now conventional terms. The distinction between consolidated and unconsolidated benefits was set out. After applying declared bonuses, the report stated at paragraph 8:

> "The balance of the total return available (if any) is allocated as final bonus. This becomes an entitlement if one of the contractual events covered by the policy (e.g. retirement or death) has occurred. In no other circumstance is it guaranteed and we refer to it, therefore, as an 'unconsolidated' benefit. The

> aggregate of the unconsolidated benefits across the total business will, on average, equate to the Investment Reserve in the published balance sheet."

This statement of practice reflected earlier comments equating policy values with the aggregate of the liabilities and the investment reserve. Given previous statements to the Board, 1989 would be the fourth successive year that ended with an excess of aggregate policy values over the with-profits fund's available assets at market value[3]. Theory was already divorced from practice, and there was never to be a full reconciliation within the reference period. The distinction drawn between contractual and non-contractual claims reflected practice going forwards: the final bonus allocation was treated as an entitlement in the former.

15. The elements of the proposed new system were set out:

> "The essence of the new system I propose is that the Board should determine explicitly a rate of allocated earnings for the year to be applied to the total policy value at the beginning of the year. Of that rate, part will be used to provide the contractual returns guaranteed under the policy, part will be used to declare a bonus (in conventional form) thereby giving growth in the consolidated benefits and the balance will serve to build up the unconsolidated policy benefits."

Worked examples were provided. The Board was advised that the unconsolidated benefit was the final bonus element of earlier practice. The key decision would relate to the year just ended and would be to determine the allocated earnings. It was said that guidelines on smoothing would be required. Final bonus tables would be dispensed with. The proposal would avoid publishing the inconsistencies inherent in the system. Discontinuities in the growth of the unconsolidated benefits would be reduced.

16. The report stated that under the old system, accidental and deliberate biases could be introduced. Typical of these biases was over-payment of longer duration maturities, which was described in this report as follows:

> "Indeed the existing final bonus rates incorporate a modest measure of bias above their natural level at certain durations where it was felt important from the point of view of published surveys to support the natural figures."

Final bonus scales had been inflated at durations targeted in the league tables. It was said that such deliberate biases would be more difficult under the new system, but not impossible. Disclosure of financial results was becoming common. The Financial Services Act 1986 had created further pressure in that direction. And the adoption of unitised products by other offices would force the Society in the direction proposed.

17. In this discussion, the author set out the intended policy of publishing total policy values, which clearly was to come to have significant PRE implications. As presented to the Board, the emphasis was on presentation. There was no assessment of the implications there might be for the operation of the bonus system, and in particular for the expectations that the presentation might generate.

18. For the board meeting on 20 December, Ranson produced a further report. It sought to put the new system into perspective. The essential difference between the old and the new systems was said to be that smoothing and averaging would be decided directly and explicitly. The results of 1986, 1987 and 1988 were expressed in terms of the new system, and the effect of smoothing was shown. The profitability criteria for non-profit business were explained. There was general discussion of the approach to yields and to assets values. But no formal guidance was offered. The paper presented smoothing in percentage terms that indicated that 1988 produced a break-even position and 1986 and 1987 were broadly in balance. The presentation

[3] Interpreting the report of 21 December 1988 as referring to the three years 1985 to 1987. If it referred to 1986 to 1988, this would be the fourth year.

of the three years in percentage terms did not disclose the state of the smoothing account. That was left to narrative to follow.

19. The report proceeded to comment on the current year. Markets had recovered strongly. A yield of 23% was likely. It was taken in an unrefined form for purposes of illustration. Long-term interest rates were below the yield required to maintain declared bonus levels. But it was said that in a buoyant market there was no need to reduce the bonus rate. The intended movement towards a lower rate climate was to be postponed again. Publicity was a factor. It was shown that with maintained declared rates the balance sheet would be strengthened. Since the year was one of relatively high yield and buoyant asset values, intuition would indicate a return below what was available. The paper continued:

> "18. The choice of yield to allocate depends in part on one's view of the future. The lower the allocated yield, the better the ability to withstand a year of relatively poor returns in 1990. Allocating a rate towards the top of the range may constrain our ability to shelter policyholders from the effects of a following year of adverse experience.
>
> 19. We should also take account of the asset value position. The effect of our averaging process was that our 31 December 1988 rates implied an asset value above actual market value. The difference between 'implied' and 'actual' values was increased by the element of support of results carried forward from earlier years and some anticipation of a favourable investment climate in 1989."

20. The latter paragraph was somewhat opaque. But it may reasonably be interpreted as informing the board that the good results of 1989 had to be applied in part in making good the over-allocations of bonuses before 1988, just as the previous paragraph was a warning that something should be held back as a shelter against poor results in 1990. But, even on this approach, the Board was told that allocation of a return for 1989 below the earned yield could still result in implied asset values above 31 December 1989 values. However, it was said that it could be contrary to the Society's averaging process to attempt to bring results into line with actual market values in a single year. The Board was advised that, because of the starting point, there might not be such a large "cushion" available on the asset values as might be implied by looking at yields alone.

21. This presentation failed fully to reflect the pattern over the past few years that had seen the level of reserves cut back progressively until there was consistent over-allocation, with the prospect of a continuing deficiency even after a year of very good returns such as 1989. Further, it gave no indication of the values involved.

22. This assessment of the starting position for the new system indicated that the practice in recent years of postponing the realignment of declared bonus, plus the "supporting" of terminal bonus payments, largely related to market position, had drained the Society's reserves. Aggregate policy values at the start of the new regime exceeded the market values of assets. The opportunity to correct over-distribution in 1989 was not taken. And, as it turned out, any confidence in 1990 would have been misplaced.

23. There was a further report for the board meeting on 24 January 1990. On preliminary assessment, and taking account of the surplus earnings on non-profit business, it was said that there was a probable surplus of 26%. The arguments for maintaining declared bonus rates were said to have remained valid but the Board was advised that it should not distribute the whole surplus that was available because the Society had been over-distributing:

> "As has been mentioned on previous occasions, for various reasons, the 31 December 1988 policy values were somewhat above the market value of assets. In other words, we were in the part of the smoothing cycle ... where we were 'over-distributing'. That leads to the view that we should, on this occasion, not distribute the whole of the return of 26% available for with-profits business,

> thereby bringing asset values and aggregate policy values more closely into line."

On the other hand, the Board was warned that they might affect competitive position by being unduly cautious. A 20% allocated rate would leave the Society "marginally" over-distributing. But that was recommended. From the minutes of the meeting, it appears that on this occasion there was discussion and the actuary "was asked to take the points made in discussion into account when forming his final recommendation". What these points were was not disclosed.

24. This was an important stage in the development of bonus policy. The Society had the opportunity to exercise a degree of restraint and restore equivalence between policy values and assets at the beginning of a new bonus system. It resolved to continue to over-allocate, motivated by competitive considerations. If the Society were indeed in a smoothing cycle, its characteristics, both as respects time intervals between peaks and as respects acceptable variation from a norm had never been specified.

<u>*With Profits Without Mystery* – the Edinburgh presentation</u>

25. On 19 February 1990 the paper *With Profits Without Mystery* was presented to the Faculty of Actuaries in Edinburgh. Headdon introduced the paper and intimated that the new system had been implemented for 1989, earlier than anticipated. In addition to the information on bonus practice referred to, he returned to the "myth of the estate". The Society, he said, did not have one. He challenged those who maintained that there were advantages in an estate to disclose them.

26. The discussion in Edinburgh covered much of the ground dealt with at the Institute meeting a year earlier. The possibility of smoothing from a deficit was questioned by one contributor who clearly understood the current position of Equitable. Another was critical of the practice of ignoring the centrality of guarantees. He thought that combined asset shares should be less than the value of the fund. The need for an estate was asserted and rejected. Mike Ross, of Scottish Widows, championed stochastic techniques for assessing and covering risk. In the period between the two presentations Ross had published a paper: *Modelling a With-Profits Life Office*, presented at the Institute in July 1989. He advocated the use of stochastic techniques in determining the target relationships between guaranteed benefits (basic benefit plus reversionary bonuses) and terminal bonus; deciding reversionary bonus levels; deciding terminal bonus levels, and smoothing. On his approach, the balance between guaranteed benefits and terminal benefits was crucial because of the impact it had on investment policy, the ability to expand, and solvency. The contrast between the Society's generally deterministic approach to assessing risk and the statistically-based methodology applied elsewhere in the industry was defined in these publications.

<u>The Managed Fund Approach</u>

27. It is clear that most of the theoretical issues confronting the industry were the subject of open discussion at this time. The Society's actuaries were involved directly in the professional debate. Their professional colleagues had not been slow to offer criticism of their approach. Ranson and his colleagues at Equitable showed no inclination to waver. The scene was set for the 1990s. The Society's approach was to be put to the test by market volatility, in many respects as forecast by critics of the paper. Perhaps it would have required particular strength of character or a well-developed humility to have changed course in the light of experience of the early 1990s. In any event the Society did not do so.

28. In April 2002, Charles Thomson, the present chief executive of the Society, distributed a circular to policyholders in which he commented on the system:

> "We have inherited a unique and unsatisfactory bonus methodology. The apparent clarity of 'policy values' creates a false sense of certainty. From the reaction to last July's announcement it is clear that Equitable Life's apparent

> transparency has, in fact, created considerable confusion. In a with-profits fund, 'policy value' only has meaning when the contract reaches maturity or at an event during the lifetime of the contract when benefits can be taken. At any other time 'policy values' can only give an indication of the approximate value of the underlying assets at a given moment. But this value cannot reflect the value of the assets at a subsequent date, the unrecovered costs or the impact on the fund of the behaviour of other policyholders.
>
> Certainly 'policy values' take no account of the active financial management which our with-profits fund needs in its current position because so many policyholders have great flexibility as to when they can take retirement benefits. That flexibility allows policyholders to take their benefits when the assets of the fund are depressed which is obviously to the disadvantage of continuing policyholders."

29. This constituted a serious indictment of the management policies of the 1989 Board. There are issues as to whether Thomson's comments fully reflected the reality. Ranson's report of 20 December 1989 indicated that for 1988 and 1989 aggregate 'policy values' exceeded the market value of the Society's investments. The 'policy values' approach therefore allowed management to give an indication of value to members that did not relate to the value of the underlying assets at the time. Subject to that qualification, the circular highlighted deficiencies in the Society's approach. The advertisement of 'policy value' to members who had reached an age at which it was open to them to take their benefits allowed those with the financial acumen or appropriate advice to elect for an early maturity date and crystallise their benefit entitlement at an unduly high value to the disadvantage of continuing members. In the early 1990s, this was facilitated by new flexible products developed by the Society.

<u>The position at end 1989</u>

30. 1989 was a year of considerable success in increasing business. The Society's investment experience was good. There was net asset growth of 37% with capital appreciation of £700m. In his presidential statement for 1989, Professor Smith continued to celebrate the Society's achievements. He said that the Society had achieved a significant increase in new annual premiums and a major leap forward in single premiums. There were material developments in the bonus system. The new position was set out in the management report in the accounts:

> "Under recurrent single premium contracts the policy is essentially building up a fund of money ... Part of that fund at any time will consist of the value of the guaranteed benefits (those secured by the premiums paid and declared bonus additions). The remaining, unguaranteed, part represents the final bonus that would be paid if the policy benefits became payable immediately.
>
> Previously the Society has determined the final bonus element under a recurrent single premium contract at any time by reference to a specific scale of rates. That has now been changed to bring the system more into line with the 'accumulating fund' nature of the contract. Each year the Society will announce a rate of growth at which the total policy benefits were built up over the year of the declaration, together with a second rate to apply for the period beyond the date of the declaration.
>
> The guaranteed part of the total benefits continues to grow as before, through the operation of the basic contract terms and declared bonus additions. The final bonus element of the policy value at any time is the difference between the total value and the value of the guaranteed part."

The Society had finally and explicitly embarked on a course that was to have significant implications for generations of policyholders' reasonable expectations in later years.

31. The commentary in the president's statement and in the accounts presented the elements of the Society's new bonus system in the context of a representation that each policy built up a fund, and had an associated 'policy value', part guaranteed, and therefore payable whatever the state of financial markets at maturity, and part not guaranteed, but depending on market fluctuations. The non-guaranteed element was not presented as an accumulation of prospective final bonus allocations. The elements of the computation were the total policy value, arrived at by applying the total allocation rate for the year, and the contractual benefits. The prospective final bonus was the difference between the two. Members could compare the total allocation with the return on the fund.

32. The Society's financial position at 1989 is summarised in table 4.1. Net asset growth was 37%. Premium income (net of reassurances) grew from £622m in 1988 to £1 billion in 1989 representing annual growth of 67%. Premium income included £642m relating to new business premium income of which £408m was written as single premium business[4]. Investment income received for the year was £298m. The investment yield achieved for the year was 6.1%. The surplus of income over expenditure for the year was £781m (1988: £499m), which represented "net new money" available for investment. A total of £317m of capital appreciation was transferred from the investment reserve to the profit and loss account. £101m of this covered the amount of final bonuses paid during the year, while the remaining £216m was used to augment actuarially determined surplus to give a total surplus available for distribution of £237m. Once again, all but £1m of this was distributed to policies as declared bonus. As at 31 December 1989, in addition to any inner reserves in liabilities, the Society had £1 billion (1988: £618m) in un-appropriated reserves, which represented a solvency ratio of 21% (1988: 17%).

Table 4.1: abridged 1989 balance sheet

	1988 £m	1989 £m
Investments at market value	4,108.9	5,661.0
Current assets	123.4	143.1
Total assets	4,232.3	5,804.1
Current liabilities	69.3	99.1
Net assets	**4,163.0**	**5,705.0**
Long-term business fund	3,544.8	4,704.1
Investment reserve	618.2	1,000.9
Total fund value	**4,163.0**	**5,705.0**
Investment reserves:		
- Opening position	523.8	618.2
- Movement	261.4	699.7
- Capital appreciation treated as surplus	(167.0)	(317.0)
- Closing position	**618.2**	**1,000.9**

1989: A Turning Point

33. As stated at the end pf the last chapter, 1989 was also a year of material change of direction. Until 1972, the Society had a conservative and relatively unsophisticated approach to bonus, concentrated on reversionary bonuses. Capital appreciation was used sparingly: not more than one-tenth of the appreciation at any time was considered available for distribution.

34. Terminal bonus was introduced in 1973 as a marginal adjustment of total allocations at maturity. The three-call system of reserving provided a rational basis

[4] See financial tables, tables B.3 and C. 3.

for the appropriation of capital appreciation. The system was conservative, making full and prudent provision for future reversionary bonuses during the projected period of deficiency of actual investment returns as against the benchmark yield on gilts. The terminal bonus 'fund' was the balance of capital appreciation, initially off-balance sheet, but in and after 1982 shown in the investment reserve. Allocation of the investment reserve to terminal bonus was made on a three-year rolling average.

35. The adverse market conditions of 1973 and 1974 undermined the assumptions on which the three-call system had been based. The system was suspended. The full system became possible in a realistic sense only in the period 1979 to 1982. But by then strict adherence to the benchmark would have generated unacceptably high reversionary bonuses, and second call reserves, squeezing terminal bonus and threatening it at critical times. Competitive forces became a material factor, and the second call was eroded and finally abandoned. Terminal bonus and the investment reserve were inflated accordingly, and the Society changed the bonus mix progressively towards terminal bonus, reducing the proportion of surplus allocated to declared bonus. Response to market conditions inhibited implement of a declared policy of moving towards lower declared rates. But available resources were increasingly directed towards increasing terminal bonus.

36. In 1986 and 1987, the sums available in investment reserve were supplemented by the appropriation of general reserves amounting to £4m to massage total payouts on pensions business at sensitive durations, taking the Society into a position of over-distribution by the end of 1987 at the latest. Adverse market conditions aggravated the position, and an excess of aggregate policy values over available assets continued into 1988. In 1989, when there was a good return, the Society deliberately distributed a high proportion of the available return for market-related reasons, and accordingly entered the 1990s with a negative estate.

37. Over this period there were references to smoothing as an inherent characteristic of with-profits business. There was at no time a statement of the Society's smoothing policy. There was no specification of smoothing parameters. It would have been possible to consider the restoration of reserves between 1976 and 1982 as part of a smoothing process, if the parameters had been defined. From 1982 until the end of the decade, the Society had progressively weakened its reserves until a negative position had become established. If there had been a smoothing cycle, it was without defined limits of value, and it was without defined limits of time.

1990 to 1993: Deficit and Recovery

1990: a Difficult Year

38. 1990 proved to be a difficult year for the savings industry. By the end of the year, equity markets had become unstable, and there were material losses against opening values and acquisition costs on transactions entered into early in the year. However, the picture at the year-end cloaked material changes over the period. The Society began the year with considerable enthusiasm for equity investment. Ranson presented an investment considerations report on 28 March 1990. The paper reported a significant increase in the proportion of equity investments within the total mix. Equities had outperformed up to that point and there was a natural element in the growth. But there had also been a bias in the investment of new money. The comparative position over the period 1985 to 1989 was set out. The essence of the table was a strong movement from fixed interest investments to equities, both UK and overseas, moving in the aggregate from 47.5% in 1985 to 63.7% in 1989. The implications of this change of balance were discussed.

39. The paper went on to consider investment strategy in the context of a range of specified 'risks': regulatory insolvency, mismatching, the commercial risk that a surplus would not be available when required, and the commercial risk of being unable to produce total policy proceeds. These were all factors in the contemporary professional debate. Investment shock from a collapse in equity values was not

presented as a serious risk. The position at 31 December 1989 was said to have been stronger than at the end of 1988. The Society could withstand a 25% fall in value of its equity portfolio before the regulatory minimum margin would be uncovered. The position was said to be very satisfactory. But the increasing proportion of equities in the total investment mix was to prove a material weakness by the end of the year.

40. Matching, both in terms of currency and assets-liabilities, was discussed at length. The investment implications of the earlier discussion were then set out. The report stated:

> "29. In recent years we have had to rely increasingly on transfers of capital to revenue to support the annual declarations of bonus. That is a natural consequence of changing investment conditions and our changing asset mix. ... If we are to maintain declared rates at relatively high levels and wish to avoid sharp fluctuations in the level of those rates from year to year, we are dependent on there being adequate capital appreciation available at the end of each year to support the required transfer...
>
> 31. If one is to add to the guaranteed benefits more quickly by declaring bonuses each year above the level supported by the income stream then one must look for sufficient capital growth to meet the cost of those bonuses whilst maintaining a satisfactory level of capital protection. For example, to support current bonus rates (requiring earnings a little above 11% p.a.) a wholly equity portfolio would need consistently to produce around 7% p.a. capital growth. In my view, given the size of our investment reserve, the extreme policy of a wholly equity backed with profit fund would be likely to involve too high a degree of risk. The Society's rapid expansion, which is probably relatively greater than for most other offices, militates against a substantial investment reserve since the younger the business, the lower the investment reserve relative to basic reserves."

The Society's dependence on capital appreciation to sustain distribution policy could not have been more clearly stated.

41. Ranson recommended continuing with a mixed portfolio with a suitable fixed interest component. It was said that freedom to manoeuvre would be improved if the Society were able to reduce declared rates further. The assets mix was said to reflect constraints arising from the nature of the business. The report continued:

> "38. We must also seek to minimise the extent of constraints wherever possible. In addition to an appropriate declared bonus policy, as has already been mentioned, it is also worth noting two significant moves on the product design front:
>
> (a) The introduction of 'recurrent single premium' life contracts with no guaranteed growth at all. The vast majority of this business is sold in the form of single premium bonds, which are particularly helpful in contributing rapidly to the build-up of the investment reserve.
>
> (b) The introduction of with-profits annuities. These are proving very popular and a sizeable proportion of the business would probably otherwise come to the Society as conventional fixed annuities. Again the contract is technically efficient and it is helpful to have this single premium business in with-profits rather than non-profit form."

42. In the immediate context of the report, minimising investment constraints reflected confidence in the equity markets and the prospect of sustained growth in market values. But the timing of the introduction of the new classes of business was significant. In 1988, there had been a radical change of product with the introduction of the former classes of new personal pensions with no guaranteed annuity conversion rate. The investment roll-up rate continued to be a feature of pensions business, and there were investment roll-up rates implicit in endowment

business. Non-profit bonus scales implied anticipated rates of return. The Society's contractual obligations generated reserving requirements. With the new classes, the Society was moving towards business that would reduce reserving requirements. There were investment implications as a by-product of that.

43. The comments, in the context of the time, showed that however it was expressed in terms of actuarial circumlocution, the Society now had an interest in policy forms that would generate relatively lower technical provisions or mathematical reserves and increased equity investment potential correspondingly. The rapid build up of the investment reserve envisaged implied the application of liability valuation techniques that ignored non-guaranteed bonus additions. Discounting new contributions below face value added to the rate of growth of the investment reserve. A similar approach to policy design was to recur later, in 1996 with the withdrawal of the guaranteed investment return of 3½%, and in 1998 with the removal of all guaranteed growth from new business.

44. Ranson said that the paper had taken a deliberately different stance from previous reports. It had brought out the Society's fundamental dilemma. The nature of the business and the recent expansion constrained the Society to have a suitable fixed interest component in the asset mix, but that component dragged down overall performance. The position had been exacerbated by holding a higher proportion of fixed interest assets than necessary. It was said that the Board needed to look to maximising returns within the applicable constraints. The increased proportion of the total funds held in equities had provided the high total return of 1989, but it exposed the Society to increased risks associated with market volatility. The bonus structures were now heavily dependent on continuing capital appreciation. With the collapse of the market later in the year the significant shift to equities was to prove damaging. However, at this stage of the year, the policies recommended by Ranson were strongly biased towards equity investment with a view to capital appreciation, and product design changes that would facilitate increasing investment freedom.

45. Bonus strategy was discussed earlier than usual. On 26 September Ranson produced a report on bonus. He observed that there had been a worldwide fall in equity markets that indicated the likelihood of a negative return for the year. The report set the tone of discussion by inviting the Board first to identify what it felt to be the "right" result in bonus terms and then to consider the extent to which that could actually be achieved in practice. The policy objective was expressed as follows:

> "2. In a time of depressed market values there are significant constraints on what can be achieved technically or within the current regulatory regime. I think, however, that our approach should be first of all to identify what we feel to be the 'right' result and then to consider the extent to which that can actually be achieved in practice."

The fall in the markets was said to make it unclear what a smoothed return for 1990 should be. There was a re-formulation of the approach to benchmarking:

> "4. I think, therefore, that we need to return to basics. In essence we offer our with-profits policyholders an investment in a mixed portfolio of professionally-managed assets. It seems reasonable to assume that, over time, such a fund will out-perform money on deposit. A 'deposit rate' return could, therefore, be regarded as the minimum that a policyholder might expect to receive in respect of any one year.
>
> 5. Over 1990 it has been possible to earn 14-15% on deposits. To the extent that new money has been invested in other types of asset, it does not appear an unreasonable approach to assume that eventually those assets will earn 14-15% in respect of 1990. A similar argument can be made in respect of existing assets, otherwise they would theoretically have been switched. In other words we are talking about a timing problem."

46. The suggestion that eventually fresh investment would earn 14-15% "in respect of 1990" raises a number of issues. Not least of these is the extent of the

directors' understanding of the implications of this advice. Presumably, the assumption included revenue and capital growth. Seemingly, it was thought that those factors in combination would compensate for the income foregone in the current year and in later years. That was why equities had been bought. But anticipating future growth and relating it back to an earlier year seems particularly questionable in purely financial terms, and may have been imprudent at a time when the only reality was that markets had fallen, and were as likely to continue to fall as to rise in the short to medium term. Further, the effects of time were not taken into account. The slower the rate of recovery might be, the longer it would be before any future increase could be available. The impact of inflation was not mentioned. Fundamentally there must be a difference on rational grounds between hoping for future compensatory yields and anticipating such yields.

47. The suggestion of a "return to basics" appears rather opportunistic in the light of policies articulated in recent prior years: it returned to the notion that a fixed interest rate return, specifically on this occasion a deposit rate, could be regarded as a minimum, since investment in a mixed portfolio produced lower revenue results than might have been achieved otherwise. The weakness of the argument was exposed by the recognition that one might never get a compensatory return. Therefore, Ranson advised, the rate should be reduced arbitrarily, to "say 12%". The report stated:

> "7. The with-profits policyholder has not bought a unit linked policy which directly follows fluctuations in market values, he has been told about the smoothing and averaging approach to with-profits business and he will be surprised if his contract does not grow at least in line with something like average deposit rates. I believe that as a starting point for the returns to be allotted over the year we might think of something between 12% and 15%. That is consistent with the earnings required to support a declared rate at last year's level of £7.50%.
>
> 8. A return at the 12% to 15% level would be more than sufficient to maintain long-term pay-outs at their 1990 levels but would lead to some reduction in published 10 year results. That is likely to be true for other offices also and is consistent with the information that the Norwich Union have published in their 'with-profits guide'.
>
> 9. The most technically and financially efficient way of allotting the return for the year would be to apply it wholly by way of an increase in the 'unconsolidated' or 'final bonus' element of policy values. This element is not guaranteed, requires no capital to finance it and is only paid out on policies leaving the fund. Hence it is very well suited to the situation where future earnings are being anticipated. If it eventually emerges that we have 'got it wrong', the damage is limited and room for future manoeuvre is retained."

48. The rates of return discussed were not based on present reality: nor was there any logical justification for the selection of the assumed return. 14 to 15% could have been obtained on deposits, but that was not the pattern of actual investment. Equities might produce such a yield in due course. That was no doubt the hope. But the rationale for the range selected was simply that it would produce the result desired, i.e. maintaining existing rates.

49. The report went on to discuss the proportion of the total return that could be consolidated. That involved reserving considerations, and could reduce the investment reserve. Significantly, Ranson commented, in relation to declared rates, that:

> "In technical terms, any presentational problems created by declaring a bonus can almost certainly be mitigated by weakening the valuation basis."

The comment introduced the current Board to the possibility that actuarial adjustment of the liability valuation could offset the consequences of reduced asset values at the year-end.

50. The Board was not invited to take any decisions on the basis of this material. But it was clearly intended to influence thinking. The summary included these comments:

> "... we now show policyholders how their policy values roll up from year to year at an overall rate of return. It should not really matter to what extent that roll up rate is consolidated by way of declared bonus or left in unconsolidated or final bonus form providing policyholders have confidence in us.
>
> - allotting the 1990 return in wholly unconsolidated form would retain a significant amount of freedom, freedom which might eventually be required in respect of 1991.
>
> - it seems to me, at this point in the year, that a case could be made either for maintaining declared rates at £7.50% or for having no declared bonus at all. Both courses of action contain significant risks. Maintaining declared rates would result in a significant technical and financial weakening of the Society whilst having no declared rate would run significant public relations risks. There seems no objective basis for an intermediate position and such a position would bring in train both types of risk."

The Board were encouraged to consider the extremes.

51. A further report was presented on 28 November 1990. The final bonus rates published in February as interim rates forward for 1990 clearly had become an embarrassment. The rates were effectively passing on a return of 15% gross and 12% net in respect of 1990. Ranson recommended that from 1 December these rates should be reduced to 12% and 10%. He set out the technical adjustments required. He advised the Board should take advantage of the reservation of discretion and alter the rates. Where illustrations had been issued, the Society should honour them. But transitional adjustments were required to prepare the way for the declaration. Stripped of detail, the rates should be reduced.

52. There was an incidental factor of potential importance in the context of the annuity guarantee debate. The actuary advised the Board that the final bonuses for retirement annuities, personal pension, or pension arrangements by individual or group policies which matured in the relevant period should be reduced from 15% to 12%. The directors were advised to "reserve the right to reconsider the rates of final bonus at any time". There was no suggestion of any need to differentiate within the classes specified.

53. For the board meeting on 19 December there was an update on progress. The position was said to be likely to be more difficult than for some time. It was "increasingly likely that we shall not be 'baled out' by a dramatic improvement in conditions" before the year-end. In discussing alternatives the Society did not have a free hand. The Board was assured that the Society had a strong business:

> "... we have strong business flows, expenses are well controlled, our with-profits policyholders are told that future bonuses will depend upon future investment returns and we have relatively low guarantees. Unfortunately the regulations bite despite that."

Ranson said that there were external constraints. Returns of −10% were anticipated, the worst since 1974 and 15% worse than 1979. The paper proceeded:

> "The current regulatory regime does not permit the sort of action taken at the end of 1974; there are now significant restraints."

54. The report proceeded to set out the regulatory constraints. There had to be an excess of assets over liabilities at least equal to the minimum guarantee fund. If the excess were greater than the minimum, but less than the required solvency margin, the Society could use a future surplus implicit item. That might be regarded as a weakness by external commentators. Assets had to be valued on the basis set out in the regulations, effectively at market value. There was no room for manoeuvre on

that side of the comparison. Ranson said that any difficulties on the public presentation could only be overcome by changing the value placed on the liabilities. Liabilities had to be established on prudent assumptions. There were regulatory constraints. But he had carried out calculations and considered that in the absence of a further sharp fall, he should be able to value the liabilities within the regulations and produce surplus:

> "Looking at this year alone, it is... fairly unlikely that we shall be unable to do what we should like."

It was noted that the Society should be able to declare at the previous level and meet its minimum requirements. The report discussed forward projections to the end of 1991. It was said that if markets recovered to yield 10% the policy of maintaining bonuses might be acceptable. Investment strategy could be altered to improve yield and, if "the situation became really desperate", some of the existing portfolio of assets could also be switched – at least in theory. The issue was presented as fundamentally about smoothing. When violent changes in earning occurred normal averaging processes broke down. But the relationship of the proposals to any specified smoothing policy was not described.

55. In a brief report dated the same day, the views of the investment committee on likely investment conditions in 1991 were summarised by Sherlock. It was felt that the underlying situation, particularly in the UK, might be worse than portrayed, but that markets would look through the gloom to better things, albeit possibly short-term, in 1992. The committee accepted the forecasts in Ranson's valuation paper as a reasonable basis for planning. For 1991, a reasonable estimate of total return was 13.6% (of which 7.1% would be income) for solvency and bonus matters.

56. On 23 January 1991, Ranson stated that he had discussed with the Board the mechanics of the issue: an increase in the rate of interest used to value the liabilities. On 13 February 1991 he expressed it differently, referring to the reference data for determining the valuation interest rate:

> "In summary, the basis for valuing the liabilities is being weakened to reflect the higher yields available on assets at 31 December 1990."

According to Ranson's report of 23 January, the preliminary results showed some improvement over what had been expected. The statutory accounts would show a closing fund of £5.6 billion; assets at market value of £5.8 billion; and an investment reserve of about £210m. The overall return was –8½% with a –10% return on the with-profits fund, a little better than expected. It was intended to increase the rate of interest used in valuing liabilities in order to reflect the high asset yields resulting from current depressed asset values. There would be a reduction in reserves that would enable bonuses to be declared at 1989 levels. The DTI return, specifically form 9, would show a larger margin between assets and liabilities than simply the amount of the investment reserve. There was no evidence of an industry-wide move to cut declared rates of bonus. Dramatic action, such as passing the declaration altogether, would carry an unacceptably high risk of collapse in confidence. Offices were acting to smooth out the poor results of 1990. A deemed rate of growth of 11-12% might be appropriate. A total growth rate of 12% should be applied. That would broadly maintain the Society's competitive position. The market risks of cutting declared rates were discussed. In summary:

> "14. The course of action described above is not, of course, without risk. Although it has been possible to reduce the liability valuation to permit a declaration at last year's level, the scope for further weakening in the face of another year of low earnings would be seriously constrained. In crude terms, the viability of the action described above relies upon the achievement of better investment returns in the relatively short-term future. We are at risk of needing to take drastic action if those better returns do not materialise."

The Society was on a knife-edge, again.

57. On 13 February 1991, the Board considered the final valuation and declaration for 1990. The actuary's report repeated the broad strategic discussion of the earlier papers. Review of the valuation bases had allowed a bonus at the previous level. It was said that no transfer of investment reserves was required to support the cost of the declaration. Final bonus rates would be in line with previous advice. The Board was provided with a mass of detailed figures on the working out of bonus rates. But the crux of the report was in its introduction.

> "2. The Board will recall that the approach being taken to the valuation is rather different this year than in recent years. In summary, the basis for valuing the liabilities is being weakened to reflect the higher yields available on assets at 31 December 1990. The effect of that weakening will enable bonuses to be declared at the 31 December 1989 levels without any transfer from the investment reserve in the Companies Act accounts.
>
> 3. The final accounting figures, subject to audit, are as follows:
>
> | | £m |
> |---|---|
> | Market value of assets | 5,788 |
> | Revenue account fund | 5,580 |
> | Investment reserve | 208 |
>
> This will be the position shown in the Society's Report and Accounts.
>
> 4. At the January Board I indicated that the minimum level of reserves, including new declared bonuses, which could be published was of the order of £5,325m. A full revaluation is being carried out on a basis which I feel to be appropriate to the 31 December 1990 position. The results of that will be available at the Special Board meeting in the form of an addition to this formal paper. The reserves including new declared bonuses will be well below the revenue account fund of £5,580m. As intended, therefore, no transfer from the investment reserve is needed to support the cost of the declaration."

Everything was to turn on the revision of the valuation. Ranson had told GAD on 14 November 1990 that the Society was considering not paying any reversionary bonus for 1990[5]. By this means that extreme step was avoided.

1990 Report and accounts

58. The 1990 accounts disclosed a negative overall investment return, a situation that had last occurred in 1974. The principal causes to which this was attributed were persistent high levels of interest rates within the UK, inflation and the consequences for economic activity generally and corporate profits in particular. Additional contributing factors were the Gulf crisis and a slowdown in world economic activity. However, despite the evident adversity, the picture painted in Professor Smith's presidential statement to members was encouraging. He reported the year, as again, one of substantial progress for the Society; a direct consequence of the confidence existing, and that new policyholders had in the quality and integrity of the Society's approach to business. He said that the declaration demonstrated vividly the way the with-profits system protected policyholders from the full effect of short-term falls in asset values. With-profits policyholders were distinguished from unit-linked policyholders by their recognition that the smoothing out of peaks was a price worth paying for the avoidance of a trough.

59. The president's statement encouraged members to share the view that reductions in asset values were short-term. More critically it also represented the Society's smoothing practice as having enabled it to deal with the potential trough of 1990 from the "peaks" of other years, earlier or later. The Society had, however, entered 1990 with a negative estate. In reality, insufficient capital had been retained from the peak results of 1989 to recover earlier over-allocations of bonus, and the Society's prospects of recovery were speculative.

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[5] See chapter 16, paragraph 11.

60. The directors' report gave further information on the bonus declaration:

"In accordance with the Society's Articles and Insurance Company legislation, the Society's Joint Actuary (who is the Society's Appointed Actuary) carried out a valuation of the assets and liabilities of the Society as at 31 December 1990. In the light of the income earned on the fund and having due regard to prudent actuarial principles, the liabilities were valued at a higher rate of interest than was used a year earlier. The effect was to reduce the value of the liabilities. As a consequence of that there was no need to transfer any part of the investment reserve to revenue account in order to meet the cost of declared bonuses or the cost of final bonuses on policies paid out during 1990."

61. In their cumulative effect, the president's statement and the directors' report appear, in retrospect, somewhat opaque. Members reading the accounts would have been aware that there had been a loss of asset value, characterised as a short-term fall, and the directors' report would have informed them that that, among other factors, had had an impact on the valuation of liabilities. The explicit reference to the application of "prudent actuarial principles" in the circumstances was relatively uncommunicative: members might have expected that to be the norm. Critically the statement gave no indication of the implications of the reduction in liabilities for the relationship between the fund position and their individual interests.

Table 4.2: abridged 1990 balance sheet

	1989 £m	**1990 £m**
Investments at market value	5,661.0	5,758.7
Current assets	143.1	185.3
Total assets	5,804.1	5,944.0
Current liabilities	99.1	157.8
Net assets	**5,705.0**	**5,786.2**
Long-term business fund	4,704.1	5,576.1
Investment reserve	1,000.9	210.1
Total fund value	**5,705.0**	**5,786.2**
Investment reserves:		
- Opening position	618.2	1,000.9
- Movement	699.7	(790.8)
- Capital appreciation treated as surplus	(317.0)	(0.0)
- Closing position	**1,000.9**	**210.1**

62. As presented to members, the Society's financial position was as shown in table 4.2 above. Net assets grew by 1%. Other growth indicators were more normal. Premium income (net of reassurances) grew from £1 billion in 1989 to £1.3 billion in 1990 representing annual growth of 29%, a reduction on the previous year's rate of growth. Premium income included £836m (1989: £642m) relating to new business of which £578m (1989: £408m) was written as single premium business[6]. Investment income for the year amounted to £376m and represented a 26% increase. The investment yield achieved for the year was 6.6% (1989: 6.1%). The surplus of income over expenditure for the year was £954m (1989: £780m), which represented "net new money" available for investment. Despite the negative return on investments, there was no transfer, in the accounts, between the investment reserve and the profit and loss account. This would have been done on previous practice to augment the actuarially determined surplus in order to meet the cost of

[6] See financial tables, tables B.2 and C. 3.

declared bonuses of £269m and the cost of final bonuses of £155m paid during the year[7].

63. The picture presented by the report to members in the annual accounts, as set out above, was that there had been a valuation adjustment, reflecting a sound actuarial approach. It is difficult to form any view of the impression this statement would have made on the mind of a reasonably well-informed reader. On the one hand, the reference to prudent actuarial principles might have provoked curiosity about the need to make the statement at all. The member would have been entitled to assume that the accounting policies and practices of the Society always had due regard to prudent actuarial principles, and to have thought that 'due regard' implied a high standard. There might have been members who interpreted the statement as an indication that the preceding year's liability figures had been overvalued and were appropriately reduced. The consequence for the investment reserve might then have been looked on as an unqualified benefit. In such a context a statement of the relationship between the fund at market value and aggregate policy values would have been informative.

1991

64. The 1991 bonus was discussed in Ranson's March paper on investment considerations. He repeated the advice that a target return of around 15% would be needed in 1991 in order to "stand still" in terms of bonus allocation. The investment committee's forecast for 1991, made at the end of 1990, had been 13½%. The Board was advised that a return much below the most likely estimate could lead to an uncomfortable position in the sense that the published position would be sufficiently weak to attract adverse comment, unless most other offices were similarly placed. At some point the Society could also begin to attract closer scrutiny from DTI. The advice was that the signs so far were encouraging. But if a return of the order of 13-14% began to appear in jeopardy, then it would be necessary to take a serious look at the potential solvency position at the year-end. That might lead to the need to increase the yield on the fund rapidly, so as to increase the rate of interest that could be used to discount the liabilities. It might then be necessary to direct new money towards fixed interest stocks, possibly combined with some switching of existing holdings. Action of that kind would only be taken if absolutely necessary. He added:

> "18. The weakening of the liability valuation at 31 December 1990 reflected the depressed asset values at that time. As capital values regain a more normal relationship with, say, their 31 December 1989 values, I shall be forced by the regulations to begin strengthening the basis again since the liability valuation discount rate is related to the running yield on the assets. That will imply writing-up of the fund by amounts in excess of those needed merely to cover new declared bonuses at future declarations. Clearly, the higher the income yield on the fund in any one year, the greater the room for manoeuvre we shall have in the liability valuation."

The discussion assumed a Board with relatively sophisticated understanding of the actuarial issues involved.

65. The report discussed total policy proceeds:

> "If, in broad terms, we regard the 31 December 1989 position as one of balance between policy values and asset values, then in 1990 we allocated growth of 12% against actual fund earnings of around –8½%. There is, thus, a shortfall of some 20% for the year to be recovered from future earnings in order to restore a position of balance. If we allocated 12% again for 1991 then actual earnings would need to be around 30% to achieve a balanced position again by 31 December 1991. In practice the 'recovery' is likely to be achieved over a number of years. It is, however, important to remember where we are.

[7] See financial tables, table B.3.

> The fact that we have got through the difficulties of 1990, and smoothed a substantial part of the effects of that for our policyholders, does not mean that we are starting 1991 from a neutral base."

But 1989 was not in balance. The 'smoothing' achieved in 1990 took the Society from a position of over declaration deeper into deficit. 1989, though itself a successful year, failed to arrest the trajectory that had been identified from 1982.

66. On 26 June 1991, Ranson presented a report on the regulatory returns. It identified the key points in the Society's return for 1990 that commentators might give particular attention:

> "The solvency margin the Society is required to maintain has increased from £204m at 31.12.89 to £233m at 31.12.90. However, the assets available to support it (i.e. broadly the investment reserve) have reduced from £974m to £413m, reflecting falls in asset values over 1990. Accordingly the Society's published 'strength' as measured by this item has reduced from last year – the solvency margin is now covered by the available assets a little under twice, compared with cover of a little under five times a year ago. Other offices are likely to show comparable falls. It must, however, be accepted that, in an intensely competitive market, some commentators are likely to try to take advantage of this apparent weakening."

The presentation of the regulatory position as "apparent" weakening was less than helpful. There was real weakening, and it was on top of the inherent weakening of the liabilities valuation.

67. Bonus discussions at the end of the year were less explicit that usual. In October, the Board decided that all new money should be invested in fixed interest securities and deposits in order to avoid solvency difficulties at the year-end. The report for the board meeting on 27 November was in preliminary form, but shorter than had become usual. The overall message was that bonuses should be maintained, but there were some specific proposals that need to be taken note of. Ranson referred to the need to fill the 'trough' brought forward from 1990. He said that, on anticipated earnings, those who had benefited from "getting a positive return in 1990 when a negative return had been earned" should have a lower level of allocation (12%) than those who had paid new money in 1991. Higher allocations for new money would be "a bit of a bonus for policyholders who had maintained their contracts, would reward new policyholders and might be useful for marketing purposes." A differential of 3% was suggested. One of the obvious difficulties with the approach suggested was that some of those who benefited in 1990 did so on maturity, and were not in receipt of benefits to which the lower rate could apply for 1991. This was a particular example of the problem inherent in the smoothing approach adopted by the Society: the future had to pay for the excess benefits of the past, whatever the on-going position might be. There was no provision from current surplus to provide for future smoothing.

68. The Board discussed the report, and the actuary was required to expand on the Society's solvency position. He prepared a note of the discussions. He produced figures at 31 October that showed an investment reserve carried forward of £180m on total assets of over £7.4 billion and liabilities of £6.8 billion. The current situation was, the actuary said, "a little 'tight'". The Board decided there should be no more investment in equities for the remainder of the year, that there should be switching to traditional gilts from index linked stocks, and that new money should go into gilts. The reason given by Ranson for concentrating on fixed interest securities and deposits was:

> "In October 1991 we indicated that for the rest of the year a minimum of 30% net new money needed to be directed towards fixed interest or deposits in order to avoid solvency difficulties in current conditions."

He asserted that this was "consistent with a 'balanced' approach" to investment. However, it appears clear that the primary purpose was to ensure that the rates

earned on a portion of the fund would support valuation requirements at the end of the year.

69. On 22 January, Ranson submitted his preliminary valuation for 1991. The draft results showed a closing fund of £6.8 billion. The assets were estimated to be less than £7.4 billion at market value. The size of the investment reserve would depend on how much of the difference of £560m would be needed for the bonus declaration or to support changes in the valuation basis. Overall return was likely to be 13.4%, somewhat lower than had been hoped for in the autumn. He stated that there was no need to cut back on the overall allocation of 12%. But the ongoing rate should be reduced to 11% to signal the impact of declining investment yields. There was no reference to the proposed differentiation of new money. It was said that across the industry declared rates were being cut. The Society should take advantage of the prevailing climate. He proposed a cut in the declared rate to 6½%. He reviewed the competitive position of the Society in terms of total policy results. He said that there was a good chance of the Society rising in the tables.

70. In terms of valuation, the report commented on a difference in treatment between the Companies Act and regulatory returns bases. Appropriation of capital appreciation to support declaration at the intended level would be modest at £65m. He said:

> "17. Maintenance of last year's basis, whilst appropriate for benefits in force at 31 December 1990, would lead to a technical release of surplus on new money invested during 1991. That does not seem particularly appropriate in the light of investment conditions over the year and I intend to strengthen the basis in order to offset that effect..."

On the same reasoning, there would have been a technical release of surplus on new money invested in 1990. The proposed strengthening for 1991 would involve the transfer of an additional £160m from capital to revenue on top of the £65m needed to support the declaration. Ranson ended the section as follows:

> "The beginning of a move back to the December 1989 valuation basis will be a useful signal to the supervisory authorities and will demonstrate a commitment to firm actuarial and technical disciplines."

This opinion reflected a degree of discomfort with the advice the author had given in 1990. It presented the position in marked contrast to the confident statements in the published statutory accounts.

71. In terms of sales, 1991 was a successful year. Net assets grew by 27%. Premium income grew by 28%. The investment yield was 7%. The president was enthusiastic:

> "1991 was a year of impressive progress. Total new business figures for the first time went above £1bn, up a third on 1990. Such success during a period of economic recession demonstrates the validity of the Society's approach to business. We provide a service at cost, which is the benefit of mutual status. We sell predominately to a well-defined sector of the market through a small, highly trained and effective field force. Our innovative contracts are designed for our particular market, which is, of course, an especially discerning and demanding one. ....
>
> With funds of just under £7.5bn and net cash flows of over £1bn the Society is now a dominant force in the market place. That growth has been achieved very cost-effectively using our traditional methods and without prejudicing the interests of existing policyholders. Indeed growth is an advantage in a self-financing organisation. Growth in the business enables us to achieve far more for clients than a less vigorous organisation might accomplish. The kind of investment in systems and quality people which a business has to make in modern conditions requires a big financial base – and we have it."

72. The management report went on to comment on how 1991 would be remembered as a year when normal cyclical recovery in economic activity failed to materialise. The prolonged recession was largely attributed to the large debt overhang following the credit explosion of the late 1980s and the subsequent measures to curb inflation. The directors' report on valuation stated:

> "In light of the prevailing investment conditions and having due regard to prudent actuarial principles, some strengthening of the liability valuation was undertaken. The Directors decided to transfer £185m of capital appreciation to the revenue account in order to meet the cost of the final bonus paid out on policies during 1991 and part of the cost of declared bonus."

73. The financial position published in the Companies Act accounts is summarised in table 4.3 below. Net assets grew from £5.8 billion to £7.4 billion, representing total annual growth of 27%. Premium income (net of reassurances) grew from £1.3 billion in 1990 to £1.7 billion in 1991 representing annual growth of 28%. Premium income included £1.1 billion relating to new business premium of which £835m was written as single premium business[8]. Investment income received for the year was £459m. The investment yield achieved was 7.1%. There was capital appreciation that contributed to a modest increase in the investment reserve. The surplus of income over expenditure for the year was £1.2 billion, which represented "net new money" available for investment. A total of £185m of capital appreciation was transferred from the investment reserve to the profit and loss account. Of this sum, £152m was applied to meet the cost of final bonuses for the year. The balance was applied to augment the actuarially determined surplus, and contribute to the cost of declared bonuses of over £305m[9].

Table 4.3: abridged 1991 balance sheet

	1990 £m	1991 £m
Investments at market value	5,758.7	7,263.3
Current assets	185.3	216.4
Total assets	5,944.0	7,479.7
Current liabilities	157.8	112.1
Net assets	**5,786.2**	**7,367.6**
Long-term business fund	5,576.1	6,992.7
Investment reserve	210.1	374.9
Total fund value	**5,786.2**	**7,367.6**
Investment reserves:		
- Opening position	1,000.9	210.1
Movement	(790.8)	349.8
- Capital appreciation treated as surplus	(0.0)	(185.0)
- Closing position	**210.1**	**374.9**

74. The Society ended the year with investments of £7.3 billion and a net asset value of £7.4 billion. The net assets were represented by a long-term business fund of £7 billion and an investment reserve of £375m. In addition to any inner reserves in liabilities, the Society had £375m in un-appropriated reserves, which represented a solvency ratio of 5%[10].

[8] See financial tables, tables B.3, C.2 and C. 3.
[9] See financial tables, table C. 2.
[10] See financial tables, table C. 3.

1992

75. Ranson reported at the board meeting of 24 June 1992, on the need to cut back on on-going rates in anticipation of a reduction for 1992 as a whole to 10%. The rate forward had been fixed on the basis of an anticipated return of 11%. It was said that the Society needed a mechanism for a smooth transition to a lower rate. Reduction in the interim was necessary to avoid an immediate reduction at the declaration in previously quoted policy values. That was to be avoided if possible on public relations grounds. In July 1992 there was a report on revenue for the half year. Investment income was well ahead of forecast, reflecting the concentration on fixed interest investments that had not been anticipated in the forecasts. In relation to market value the report stated:

> "6.1. The estimated market value of the fund at 30 June 1992 was £8,209m. That compares with a figure of £7,368m at 31 December 1991.
>
> 6.2. The increase in the market value of the fund over the first 6 months of 1992 represented an annualised rate of return of around 9.7%. That reflects the improvement in capital values during April and May followed by a decline during June.
>
> 6.3. The excess of market value of assets over liabilities at 31 December 1991 was £516m. By 30 June 1992 that was estimated to have grown to £631m before allowing for any accrued declared bonus cost. After allowing for accrued bonuses that is a slightly weaker position than that published at 31 December 1991. The concentration on fixed interest investments this year has, however, led to a weakening of the impact of the regulatory requirements and would permit some weakening of the published valuation basis, if required."

The Board was being prepared again for difficult decisions.

76. Ranson presented a report on bonus policy on 25 November. It discussed bonus structures, repeating standard advice that aggregate bonuses were a method of distributing actual surplus at the point a policyholder left the fund. Declared bonuses were additions to guaranteed benefits under a contract. Prior to the point a person left the fund, interim, terminal or final bonuses only 'indicated' how the members' benefits were growing but without commitment. The actuary said:

> "Although such bonuses are not contractual and could in theory be reduced without notice, there is nothing to prevent an attempt to honour them."

There was no attempt to instruct the Board on the possible implications of policyholders' reasonable expectations. If unconsolidated benefits could only be reduced without notice "in theory", it would have been clear that they could not have been removed instantly in fact. There would, at least, be a transitional period during which there would of necessity be payments on maturing business. The implications for actual financial management were not drawn to the attention of the Board. The document contained a 'history' of previous experience, contrasting the post-1974 situation with the current regulated environment. It was implied that irksome regulatory controls squeezed investment freedom. Some of the comments reflected attitudes of importance. In particular, the presentation reflected a failure to consider whether there were PRE factors that might have affected the Society's ability to reduce non-contractual benefits without notice.

77. It was reported that the year presented difficulties:

> "The hangover from the poor outcome from investments in 1990 and the very erratic performance this year to date, really has meant that there are few conclusions which can yet be drawn. Whatever the Board may want to do will, inevitably have to take second place to what is technically possible."

The paper made comments on the bonuses members expected, based on stable returns not inconsistent with the yield on fixed interest investments. That was said to be the product the Society sold: it was necessary to meet expectations about the

traditional product. So far as this was a reflection on PRE it was less than comprehensive. The actuary stated that the 1970s and beyond, had been years of relative freedom from external constraints. Triennial declarations had allowed the Society to distribute in unconsolidated form in the interval. 'Intrinsic' earning power could be relied on. There were no third party interests in strength and so on. Things were different in the 1990s. Several questions were posed for discussion that reflected on the appreciation of the Board of the contemporary situation:

i. Would the negative return in 1990 ever be recouped? Alternatively would the Society ever earn the £400m required? If not there would have to be a 'discontinuity' between pre 1991 and post 1990 business? That should be considered?

ii. What kind of return would one like to see for 1992? 9% was proposed. Could the assets yield that in the foreseeable future? If not, why hold them?

iii. If 9% were the appropriate rate, was it likely to be available in distributable form? If just, there would be constraints on investment freedom.

iv. If assets did not recover, and the position became very tight, there were limited options. They ranged from passing a declaration to a reduced rate. All had significant P.R. implications.

v. There was a seductive argument for moving from guaranteed to non-guaranteed benefits. That increased investment freedom, but it carried another layer of risks.

It was said that in 1990, the directors had declared a bonus from reserves. That was not repeatable. However, the implication of the comment was that there had been surpluses in the reserves at 1990, which had been drawn on to fund the declared bonus. Ranson did not explain in what respect the 1990 declaration could be said to have been made from reserves: it had been achieved by amending valuation assumptions on a transitory basis.

78. There was a supplementary report by Shaun Kinnis, the marketing director, on the customers' perception of bonus policy. It said that customers invested because they perceived the Society to be a superior organisation, in terms of products, advice, field force conduct, administrative capability and investment performance. The Board was warned that, if any of these failed, the Society's image would be damaged. Investment policy had to be tailored to best achieve clients' expectations. The Society had to demonstrate a decisive approach because if it were suggested that it had 'dropped the ball', there could be devastating PR consequences.

79. On 25 November, the Society's secretary, Roger Bowley, prepared a note which summarised discussion at the board meeting. The discussion could hardly be described as profound. But major points identified included the need for surplus to be available; the need to recoup the excess distribution over earnings that occurred in 1990; and possible variations in the split between guaranteed and non-guaranteed benefits. It was agreed that investment policy had to be structured with an eye to solvency. It appears that at least some members of the Board were concerned about the position that had been adopted in 1990 and the situation that had emerged since. The minutes indicate that the Board discussed the position without reaching any firm decisions, and without providing the guidance sought of it by management. The general manager and general manager (investments) were required to report further for the December meeting.

80. Ranson produced a paper on investment considerations dated 10 December, in which meeting bonus targets was the predominant consideration. It was said that declared bonuses were expected to emerge in a fairly stable manner; and that overall return should not be significantly below the averaged redemption yields on gilts. The

debate was not primarily about asset mix, but about delivering the appropriate amount of surplus. Whether that was achieved by income or capital was not relevant. A regulatory constraint not previously much considered, but now discussed, was the Secretary of State's power of intervention if policyholders' reasonable expectations were not met. But there was no analysis of the implications. It was said that the possible outcome for the year was becoming clearer. Gilt rates were about 8½%. That would point to a bonus rate based on 5% over the guaranteed investment return of 3½%. If the previous return of 10% were maintained the balance sheet would be weakened. A note of caution was sounded. Looking forward to the end of 1993, it was said that the Society should look for a minimum return of 8-9%, a rock-bottom return. The general objectives set out little that was new.

81. For the board meeting on 27 January, Ranson's report set out the draft results. The return on market value was reported to have been 17.2% overall, with 18.2% attributable to with-profits business. The fund had grown a little less than projected. Alternative projections were offered for declared bonus rates of 6½% and 5%. It was reported that most offices were making significant cuts in declared bonus rates. A reduction to 5% would not be out of line with the market. It was said:

> "At the £5.00% level the total earnings required on pensions business are just over 8½%, a rate not inconsistent with long term gilt rates, our traditional guideline. At this level we should hopefully be able to avoid a further reduction in the declared rate at the end of 1993, unless, of course, long term rates fall. Furthermore, the resulting strengthening of the balance sheet compared with a £6.50% declared bonus level would provide more room for manoeuvre from the investment viewpoint."

The report commented on bonus structures:

> "8. The declared rate is only a part of the benefits and although there are clearly public relations aspects to be borne in mind, what is of importance is the overall roll-up in benefits for the year. As the Board will recall, the excess over the declared bonus rate is a non-guaranteed addition to policy values and does not need to be reserved for."

In view of the return, it was said that the 10% overall level seemed low. 12% should be the starting point for discussion. He drew attention to the need to redress the over-distribution at 1990. The minute of the meeting reflected some discussion. It was resolved that there should be a declared rate of 5%, 10% on paying out on 'old money', that is premiums paid before 1992, and 12% on 'new money' paid as premiums in 1992. Final decisions would be taken on 10 February 1993. However it appears that the Board had now accepted the advice that there was a case for distinguishing old and new money in allocating bonus.

82. Despite this assessment, Professor Smith's statement in the 1992 accounts remained optimistic. He described the Society's entry into Europe. He talked of the opportunities there, given the Society's special culture and style of operation. He referred to Equitable's high rate of growth, with success in line with its corporate plans, in contrast to the industry-wide scene where a number of major competitors had less than satisfactory new business growth. Equitable was consolidating its commanding position as one of the major players in the industry "and, of course, a very special player". He commented on the general economic picture and its relevance to bonuses. Most financial institutions were probably entering a period of lower investment returns and bonuses, in particular declared bonuses on with-profits policies, would have to reflect that. He rehearsed the Society's philosophy:

> "In the Equitable we pride ourselves on allocating earnings from our investments across all classes and durations of contract in as fair and consistent a manner as possible. The fundamental philosophy is that each generation of policies should receive benefits commensurate with the earnings produced during its lifetime. Beyond the bounds of normal commercial prudence, it would be alien to our culture to hold back benefits from one

generation to build reserves for a future generation. As we say in our literature, for new policyholders future bonuses must depend primarily upon the earnings produced on the investment of the new premiums. Any deliberate cross subsidies between generations would not be 'equitable'."

83. As appears frequently in these documents, there was an inherent contradiction in the statement. If nothing was held back for the future, any over-allocation had to be recovered from the future. That had to involve deliberate anticipatory cross-generational subsidy and to be, in these terms, 'inequitable'. He continued:

> "I believe that we can rightly claim that for as long as comparative tables of policy results have been published, the Society can demonstrate that it has provided consistently good value across all types and durations of product.
>
> The great strength of the Society is that we have a very clear view of what we are about, with the result that the whole organisation is tightly focused. We hold firmly to the mutual concept and everything we do is in the interests of our policyholders. Concentrating on our clearly-defined market sector and using our own controlled channels of distribution lead, ... to large flows of high-quality business. I believe that what your Board, management and staff have achieved over recent years, and continue to achieve amply demonstrates the validity of our approach. ..."

As between the Society and its members all was well.

Table 4.4: abridged 1992 balance sheet

	1991 £m	1992 £m
Investments at market value	7,263.3	9,333.5
Current assets	216.4	283.3
Total assets	7,479.7	9,616.8
Current liabilities	112.1	120.2
Net assets	**7,367.6**	**9,496.6**
Long-term business fund	6,992.7	8,562.1
Investment reserve	374.9	934.5
Total fund value	**7,367.6**	**9,496.6**
Investment reserves:		
- Opening position	210.1	374.9
- Movement	349.8	704.0
- Capital appreciation treated as surplus	(185.0)	(144.4)
- Closing position	**374.9**	**934.5**

84. The financial position as published in the Companies Act accounts is summarised in table 4.4. The Society continued to make a strong marketing pitch in 1992. Net assets grew from £7.4 billion to £9.5 billion, an annual rate of growth of 29%. Premium income (net of reassurances) grew from £1.7 billion in 1991 to £1.9 billion in 1992 representing annual growth of 9%. Premium income included £1.2 billion of new business of which £932m was written as single premium business[11]. Investment income for the year was £572m. The investment yield achieved for the year was 6.9%. There was capital appreciation of £704m. The surplus of income over expenditure for the year was £1.4 billion, which represented "net new money" available for investment. The overall return achieved by the Society on its assets, including unit-linked assets, was 17%. A total of £144m (1991: £185m) of capital

[11] See financial tables, tables B.3 and C. 3.

appreciation was transferred from the investment reserve to the profit and loss account. This was applied to meet the cost of final bonuses paid out during the year of £168m, and the balance was applied towards the cost of declared bonuses.

85. The Society ended the year with investments of £9.3 billion and a net asset value of £9.5 billion. The net assets were represented by a long-term business fund of £8.6 billion and an investment reserve of £935m. In addition to any inner reserves in liabilities, the Society had £935m (1991: £375m) in un-appropriated reserves, which represented a solvency ratio of 11% (1991: 5%). The results were far from spectacular.

1993

86. The bonus paper for the Board meeting on 24 November 1993 was presented in the names of Nash and Headdon. The paper for the meeting of January 1994 referred to below was presented in the same names, but "for RHR". This was a period of transition in the provision of actuarial advice to the Board in which Headdon emerged as Ranson's lieutenant in relation to liability valuation. Despite the use of Nash's name, the evidence indicates that he never made a significant contribution as valuation actuary. On the other hand, it was clearly the case that those submitting reports did not act in isolation from the Society's other actuarial staff. I shall refer to Headdon as the author for convenience, and to reflect what I understand to be the substantial reality of the situation, but I have no evidence to contest his assertion that others were involved in the work, and that Ranson would have reviewed it. As I understand the position, Headdon's colleagues would also have been brought up in the same school of actuarial practice.

87. Headdon's paper for the 24 November board meeting forecast relatively high earnings for the year of the order 20-25%. He wrote:

> "Circumstances this year have ... been somewhat unusual with a significant part of the nominal return arising from the fall in interest rates. Some of the return this year is, therefore, spurious. ... The capital appreciation experienced this year due to the shift in yield basis will be gradually dissipated over future years if the stocks are held to maturity."

He said that a return of 17½% would best represent the intrinsic return on assets. On any view, the Society's published position would be significantly stronger than in the previous year. Presentational issues would be less important. He said that the Society could focus on fundamentals in formulating decisions. He explained the differential in the allocation between old and new money:

> "That was in reflection of the relatively high earnings in 1992 and the need, on the older business, to recover part of the over-distribution in respect of 1990."

88. As noted previously, recovery from matured business was not possible. Claims crystallised benefits. Continuing policyholders alone were vulnerable to the recovery process. However, Headdon said that very high return for the year provided relief and that the "hole" from 1990 could be closed by the excess return generated. The Society had the luxury of being able to disregard the nominal increase in value of fixed interest stocks. He stated:

> "7. For 1993 we need to decide what is the appropriate rate or rates in the light of the earnings position... An intrinsic return comparable to that earned in 1992 would indicate that similar total growth rates are appropriate – i.e. around 12% p.a. We also need to bear in mind that total policy values are still above the value of the underlying assets. To some extent 1993 might be regarded as the converse of 1990. Allocation of a relatively modest rate of around 12% when 'usable' earnings are about 17% will restore the position of balance between assets and policy values. If earnings in future years are at relatively low levels the opportunity for such action may not recur for some time."

It was said that policyholders' views of what was reasonable were difficult to assess. In the light of general practice, he recommended a decrease in declared rates.

89. Headdon said that a return of 12% would need careful explanation. During 1993, fixed interest rates had fallen and were a little over 7%. There was a prevailing view that they were more likely to fall further rather than rise. On the benchmark a declared rate of 3½% was indicated. He said that a declared rate of 4% would seem appropriate. There was no requirement to cut rates "from a 'strength' viewpoint". But the market was expecting a general round of cuts. Cutting rates was seen as financial prudence, and he suggested that it would be foolish to miss the opportunity. The Board accepted the recommendations conditionally. The board minutes record discussion. The influence of the market competition as well as the position at the year-end, were recognised as crucial.

90. According to the minutes of the meeting, one director drew attention to the 1990 over-distribution, and another observed that the current year's returns were unlikely to recur in 1994.

91. On 30 November 1993, Ranson met GAD. Bonus policy was an issue. He told them that there was almost certain to be a reduction in declared rates. The official minute noted that he was expecting this declaration to eliminate the excess of payouts over asset shares which had been a recent feature. It is clear that there had been excessive distributions, in the context of declared bonuses, in fact and to the knowledge of GAD.

92. On 22 December, the Board considered formal recommendations from Ranson for the following year. A total return of 12% was recommended, with 10% ongoing for 1994. On 26 January, it was reported by Headdon and Nash (for Ranson) that the overall return for the year had been 29%. It was necessary "to 'strip out' the capital appreciation in the fixed interest portfolio to arrive at a 'usable' return of about 17%". The sharp reduction in yields during 1993 meant that the liability valuation required strengthening by reducing the rate of discount. The Board were told that in 1990, the valuation had been weakened. It had been strengthened since and would require further strengthening in the light of the yields at 31 December. Part of the capital transfer from investment reserve was required to meet the cost of strengthening the liability valuation, over and above what is normally needed at a declaration. Headdon and Nash provided information on valuation:

> "As discussed during the year, the sharp reduction in yields during 1993 means that the liability valuation needs to be strengthened by reducing the rate of discount employed. That is necessary both to meet regulatory requirements and to comply with a professional view of what constitutes an appropriately prudent basis in current conditions. On this occasion a... further transfer (of capital appreciation) will be needed to meet the cost of that strengthening, over and above what is normally needed at a declaration."

They also stated:

> "Directors will recall that prior to 1990 the liabilities were valued essentially on the premium bases but that approach had to be weakened significantly in 1990 to reflect the fall in asset values and consequent rise in the running yield on the fund. As asset values have moved up and yields fallen since then, discount rates for the valuation of liabilities have been decreased, i.e. valuation bases have been strengthened."

93. Earlier reports had discussed the need to move towards the 'traditional' basis used in 1989 and earlier years. Headdon and Nash said that a basis only a little less strong than that used for 1989 was appropriate. The recommendations and the Board's decisions for 1993 reflected the high returns achieved and the flexibility those returns gave the Society to readjust. Discounting the fixed interest gains suggests a luxury of approach that would not have been possible in less favourable conditions. One director noted with satisfaction that total policy values were now once more within the market value of the assets. The Board agreed to the

recommendation that the strategy of reducing declared bonus rates in conditions of falling interest rates should be continued, and a declared bonus rate of 4% was approved for the year.

94. There was a further marked shift from reversionary bonuses: (a) there was an absolute reduction of 1%; and (b) there was a larger relative shift in favour of postponed benefits. It had already been decided by management that adverse annuity rate conditions could be compensated for by differential final bonus allocations. There was no comment on the issue. What was said was:

> "In summary, therefore, we have substantially increased total policy values, but with a smaller increase in the guaranteed element than in recent years. We feel this is the proper response to events in 1993."

The decisions on the declaration were made on 9 February 1994. On the face of its published statements, the Society had returned to stability.

95. In his final statement as the president of the Society, Smith maintained the tone of celebration that had characterized his presidency. He stated:

> "It is pleasing to report that 1993 was yet another satisfactory year for the Society as the various policies we have been pursuing came together to produce some excellent results. New business was higher for both annual and single premiums. New annual premiums for the first time exceeded £300m in long-term ordinary branch business. This is a significant breakthrough because we believe that are the first company in the U.K. to achieve that level of production. Single premiums exceeded £1bn. These are quite remarkable results in a market which many of our competitors found very difficult, particularly in the area of annual premiums with some other major players reporting significant falls."

96. General bonus policy was discussed in the management report for the year:

> "[The] Society earned about 28% overall on its assets at market value over the year, if changes in market values for fixed-interest securities, which constitute about 40% of the assets, are included. Since, however, those particular changes are transitory, the Board has identified the total 'attributable' earnings for the year as about 17% when carrying out the averaging to determine the overall rate of return to be granted for the year.
>
> Our approach to declared bonus rates has for many years been to make a broad link between these and the redemption yields on fixed-interest stock. In the light of the sharp reductions in such yields, the Board concluded that declared bonus rates should be reduced appropriately.
>
> There is widespread agreement in the industry that declared rates need to be reduced to reflect the current levels of yields. We are aware that some offices have used the high nominal returns experienced in 1993 to defer making such reductions. We prefer to adhere consistently to our established strategy because in that way we maximise investment freedom."

The statement failed fully to reflect the discussions of bonus policy by the Board.

97. However, the year saw good investment returns. The financial position is summarised in table 4.5 overleaf. During 1993, the Society's net assets grew from £9.5 billion to £13.2 billion, total annual net asset growth of 39%. Premium income (net of reassurances) grew from £1.9 billion in 1992 to £2.1 billion in 1993 representing annual growth of 12%. Premium income included £1.4 billion relating to new business, of which £1.1 billion was written as single premium business[12]. Investment income for the year was £668m. The investment yield achieved for the year was 6.0%. The surplus of income over expenditure for the year was £1.5 billion, which represented "net new money" available for investment. A total of £1.2

[12] See financial tables, tables B.3 and C.3.

billion of capital appreciation was transferred from the investment reserve to the profit and loss account in order to meet the cost of cost of final bonuses, with the balance contributing to declared bonuses.

98. The Society ended the year with investments of £13.1 billion and a net asset value of £13.2 billion. The net assets were represented by a long-term business fund of £11.5 billion and an investment reserve of £1.7 billion. In addition to any inner reserves in liabilities, the Society had £1.7 billion (1992: £935m) in un-appropriated reserves, which represented a solvency ratio of 15% (1992: 11%).

Table 4.5: abridged 1993 balance sheet

	1992 £m	1993 £m
Investments at market value	9,333.5	13,130.8
Current assets	283.3	232.7
Total assets	9,616.8	13,363.5
Current liabilities	120.2	171.7
Net assets	**9,496.6**	**13,191.8**
Long-term business fund	8,562.1	11,450.9
Investment reserve	934.5	1,740.9
Total fund value	**9,496.6**	**13,191.8**
Investment reserves:		
- Balance available to augment surplus	374.9	934.5
- Movement	704.0	1,985.7
- Capital appreciation treated as surplus	(144.4)	(1,179.3)
- Closing position	**934.5**	**1,740.9**

1994 to 1997: Deficit and Recovery Again

1994 and the GAD survey on bonus distribution

99. The euphoria carried over from 1993 dissipated mid-year. When the Board met on 23 February, the marketing manager gave a resume of the highly successful position in 1993, and Nash reported on success in meeting corporate objectives in 1993. But by 22 June the possibility of a zero return for the year was mooted.

100. Shortly after this, on 20 July 1994, Equitable responded to a GAD survey on bonus distribution[13]. The response said that the Society's basic approach was to establish an appropriate gross rate of accumulation of total pension policy values for the year in question. That rate would be netted down for life fund contracts. Applying the roll-up rate for the year to the accumulated total policy values and the new declared bonus rates to the benefits excluding final bonus gave the required level of maturity value, with and without final bonus, at each policy term for the coming year. The relationship between those two sets of values provided a scale of final bonus rates. Some minor further smoothing of that scale was then undertaken to produce a practical scale of rates. The response stated that asset share techniques were not used directly in the process, but that in determining the appropriate accumulation rate for the year, regard would be had to the relationship between policy values and asset shares to date and projected trends in asset shares on various investment assumptions. In relation to variations of rates, the response stated that the general intention was that final bonus rates for contractual payments on conventional level annual premium business would be changed only

[13] See chapter 16, paragraph 105 et seq.

annually. But, if it became clear that earnings were significantly at variance with those anticipated, rates would be reviewed.

101. The Society's response to the survey also commented on recurrent single premium business. It stated that an ongoing growth rate, at which previous year-end values and subsequent purchases were rolled-forward to determine policy values, was an explicit part of the bonus system. That rate was effectively an anticipation of the accumulation rate which would be applied in respect of the year at the next declaration. If it became clear that the accumulation rate likely to be determined for the year was significantly different from the ongoing rate, then the ongoing rate would normally be adjusted to reduce the discontinuity in proceeds at the year-end.

102. The response dealt with surrenders, and stated that the full policy value (including final bonus) was normally adjusted to ensure that the surrender value paid did not exceed the underlying asset share. The level of adjustment required was monitored monthly. It also set out the approach to calculating asset share. The calculation accumulated a 'pure' premium (i.e. net of expense loadings and charges for life cover) at the earnings attributable to with-profits business. The actual rate of investment earnings in each year was used, and expenses were implicitly taken to be at the level covered by the policy loadings. A separate analysis of actual expenses versus loadings had shown, for many years, a good balance between the two items.

103. According to the response, the overall approach to determining the appropriate level of total policy proceeds each year automatically produced a consistent approach for contracts of different types and, within each type, for contracts of different terms and durations in force. No discrimination between different contracts was made in the smoothing process. Overall smoothing over time was determined by the relationship between the accumulation rates determined each year and actual investment earnings. That smoothing was also reflected in the comparison of the aggregate total policy values with actual asset values. In normal circumstances the directors looked to apply a 3 to 5 year averaging cycle, but expected to apply that more flexibly in more unusual circumstances. It was said that the Society did not look to maintain an 'estate' or other free assets not allocated to policyholders. Allowance was made for the accumulated new business strains that would be recouped from future premium loadings. Part of the Society's stated philosophy was to achieve a reasonable degree of stability in proceeds with gradual rather than sudden changes in proceeds. The approach to smoothing needed to reflect that philosophy, particularly in volatile investment conditions.

104. This presentation attributed to the Board a defined smoothing policy and implied application of it relative to a comparison between aggregate total policy values and actual assets values, which I have not been able to identify in the papers reviewed, and dealt with in this report so far.

105. Prior to the board meeting on 26 October, the report of the Securities & Investments Board on pensions mis-selling had been published. There was concerned discussion. Bonus policy was discussed as a strategic issue at an evening seminar on 26 October 1964. The Board met on 23 November 1994. Ranson's report stated:

> "Given the investment climate over the year to date and the relative unlikelihood of any significant change before the year end, the bonus thinking will have to be based upon general rather than investment considerations. Directors will recall that this was also the situation in 1990."

There was to be another 'return to basics' approach. It was said that the actual total returns were unlikely to provide a "helpful starting point", and that the Board would need to talk about the 'intrinsic value' of the funds. The question posed for the Board was: 'What kind of return was likely eventually to be earned in respect of 1994 that could be anticipated now?' The actuary's preferred approach was to base the overall roll-up rates on a 10% deemed rate unless there were significant

objections on investment grounds. If prospects were pessimistic one could go lower, but there would be discontinuity problems.

106. A full paper on bonus was presented to the Board on 25 January 1995. It narrated that investment reserves had fallen from £1.7 billion to £400m. The overall return was minus 5%, with a rate of minus 4.2% on the with-profits fund. It was said that virtually all offices in the market had reduced their declared rates. However, the Society had anticipated the trend, and would be vindicated by maintaining the previous declared rate. Directors were informed that movements in the investment reserve were simply a product of the valuation techniques applicable in volatile market conditions. The valuation of liabilities would be about £725m lower than values would have been had 1993 assumptions been applied. The report stated:

> "14. The Form 9 position..., although satisfactory in technical terms, is rather weaker than one might wish for public presentation purposes. These are, however, first draft figures and it may be possible to achieve a stronger ultimate presentation due to the following points:
>
> (i) when the detailed valuation results are scrutinised it may be appropriate to reduce the value placed on the liabilities further;
>
> (ii) the regulations are especially harsh in their treatment of equities, in that no account can be taken of future dividend increases or capital appreciation. This is illustrated by the fact that, were the fund wholly invested in gilts, the valuation of liabilities could be reduced by at least £1500m. There is a mechanism to bring some credit for this factor into the Form 9 presentation by including a 'future profits' item. We have obtained approval to use such an item, which in our case could amount to some £450m, from the DTI. Careful consideration does need to be given as to whether or not to use this item since, as few offices do make use of it, its use could be perceived as a sign of weakness by commentators."

In the discussions at the meeting, the managing director emphasised the need for continued growth. The marketing manager presented 1994 as a somewhat disappointing year. The valuation and declaration at year-end 1994 was discussed. The Board agreed to maintain the roll-up rate at 10%. On total policy payouts the minutes stated:

> "Having actually earned –4% the Society's Directors need to assess the intrinsic value of the assets and to have regard to the implicit assumption that there will be the relevant level of outperformance within a reasonable future time-frame to recoup the shortfall."

107. Future profits were effectively mortgaged by the decision. The approach was similar to that adopted between 1990 and 1992. It was said that unless views of future investment performance were pessimistic there was no need to reduce the roll-up rate below 10%. Competitive positions were explored. In the end the valuation of liabilities was about £725m lower than values would have been had 1993 assumptions applied. It is difficult to reconcile what was done with the response to the GAD survey.

108. The formal declaration meeting was held on 8 February 1995. Ranson delivered a talk on the respective responsibilities of the Board and the appointed actuary for the statutory and regulatory accounts. The bonuses were approved.

109. On the face of it, this was another disastrous year for the Society. Yet declared bonus rates were maintained, on a 'return to basics' approach. Total returns were cut back. The income shortfall could not be met by capital appreciation: it had to come out of reserves or future gains. It appears clear that the Society attempted to remain competitive in terms of bonus allocations and actual payouts when in a weakened financial position, and having no protection from a free asset estate.

110. The Society reported a return of minus 4.2%. Bonus levels were maintained at 1993 levels. Published statements attributed the ability to do this to the benefits of the with-profits system as operated by Equitable. In practice, the Society achieved distributable surplus by changes in its valuation assumptions.

111. The reported position from the Companies Act accounts is summarised in table 4.6. Financial performance was poor. The Society received a net cash inflow of £1.5 billion of new money available for investment. Net assets grew from £13.2 to £13.5 billion, representing total annual net asset growth of 3%. Premium income (net of reassurances) fell by £49 million in 1994 to £2 billion, representing an annual decline of -2%. Premium income included £1.3 billion relating to new business of which £1 billion was written as single premium business.[14] The investment yield achieved for the year was 5.6%. The investment return of minus 4.2% reflected a disclosed unrealised loss on investments of £1.5 billion. In order to augment surplus to a level required to meet the cost of declared bonuses reserves of £790m were transferred from the fund for future appropriations to profit and loss account.

112. The Society ended the year with investments at market value of £13.2 billion, a net asset value of £13.5 billion. Technical provisions of £12.4 billion and a fund for future appropriations of £1.2 billion represented these net assets.[15]

Table 4.6: abridged 1994 balance sheet

	1993 £m	1994 £m
	Restated	
Total investments	13,112.8	13,196.1
Current assets	465.0	566.4
Total assets	13,577.8	13,762.5
Current liabilities	170.8	217.5
Net assets	**13,407.0**	**13,545.0**
Technical provisions	11,443.1	12,371.3
Fund for future appropriations	1,963.9	1,173.7
Total fund value	**13,407.0**	**13,545.0**
Fund for future appropriations:	Restated	
- Opening balance	1,146.6	1,963.9
- Transfer (to) from the P&L account	817.3	(790.2)
- Closing balance	**1,963.9**	**1,173.7**

113. The new president of the Society, John Sclater, introduced a new style in presidential statements. He discussed the Society's methods and 'mission' before turning to the financial results for the year. He commented:

> "I am glad to be able to report to you that in 1994 we had yet another highly satisfactory year. Our new annual premium and single premium business in the U.K. was only a little below the levels achieved in 1993, a situation most of our major competitors would have been pleased to emulate. ..."

In relation to bonus, he commented:

> "The bonuses which are added to policies are of the greatest importance to all our members. This year we have seen the benefit of the with-profits system in smoothing out fluctuations in investment returns. Most fund managers with balanced portfolios, including ourselves, suffered negative investment returns

[14] See financial tables, tables B.4 and C.4.

[15] See financial tables, table B.4.

> last year. However, your Directors have been able to maintain the bonus rates at the levels established at the beginning of 1994. Our philosophy is, as ever, to produce consistently fair and attractive results across the full range of our policies."

The management report commented on the state of the markets during the year:

> "In most of the world's financial markets the experience in 1994 was akin to a major hangover following the euphoria which had existed at the end of the previous year. The combination of strong economic growth and fears of higher inflation led to interest rate increases in the U.S. and, subsequently, in the U.K. This proved uncomfortable for speculative funds which had borrowed heavily to invest in rising bond and equity markets, and the consequent weakness of bond prices persisted for most of the year. Despite the increase in corporate profits therefore, share prices generally failed to rise through the year and in many cases closed at lower levels than 12 months earlier. However, the increase in property values, together with rental income, meant that the Society's property portfolio provided a significant positive contribution to the return on the fund, thus demonstrating the value of holding assets whose performance is not directly correlated with the principal securities markets."

114. Despite the Society's investment performance, the directors decided to allocate an overall rate of return of 10% per annum for recurrent single contribution pension contracts. That rate applied to actual maturities during the year. The Society's ability to do this given its actual performance was attributed to the benefits of the with-profits system, with its ability to smooth short-term peaks and troughs of investment performance. As it was the Society's strategy at this stage to mirror the redemption yields on gilt edged securities in its declared bonus rate, declared bonus rates were held at their 1993 levels, consistent with current market yields. Looking ahead, the managing director and actuary, stated in his report to members:

> "[B]ecause of the Society's strong position - based on its mutuality, effective marketing, low expenses and willing acceptance of the need to change - we have the opportunity of increasing further the Society's market share in the U.K. and internationally, to the benefit of both our existing and new policyholders. Our staff and systems are ready and able to deal with these increases efficiently and cost-effectively. We are confident that the next few years will bring considerable growth and continued success to the Society."

The pursuit of growth remained at the forefront of policy.

1995

115. On 22 March 1995, a director raised the issue of the Society's free asset position and there was discussion. Ranson commented that:

> "... the Society did not have an unrealistically large level of free assets, unlike some other offices, because the Society had always followed a proper and full bonus distribution policy."

On 22 November, members of the Board returned to the issue of free assets. There had been adverse comment in the market about the level of the Society's free asset ratio. It was minuted that:

> "The Managing Director and Actuary (RHR) reiterated the Society's different approach from others and the reason for the level of the free asset ratio. He explained the intention to mount a campaign with consulting actuaries in the New Year, as well as the plans to give members fuller information in the Report & Accounts for 1995 when it is prepared. The President asked for presentation of absolute figures of the free asset ratios of various companies to be produced."

These questions demonstrated a level of challenge of the actuarial approach that had not generally been noted in the board minutes. Justification apart, the questions reflected appreciation of the narrow margins on which the Society had been operated.

116. The Board discussed the preliminary report on bonus distribution for the year on 15 November. The report for the meeting was brief. It was expected that after two volatile years, 1995 would be a more 'normal' year. Earnings were expected to be about 15%. Policy values were currently being rolled up at 10% per annum. There was reference to the benchmark for the aggregate of the guaranteed roll-up rate and the declared rate of bonus being broadly the prevailing yields on gilt-edged securities. Current yields were said to be above the current roll-up of 7.6%.[16] The report commented on the likely position. The actual earnings on assets for the year were likely to be somewhat higher than the 10% per annum roll up rate for those leaving the fund.

117. Headdon's report stated:

> "10. In the last 6 years there have been 2 years of negative return (1990 and 1994). For each of those years regard was had to the intrinsic value of the assets and policyholders were largely protected from the effects of the adverse experience. Another way of looking at that is to say that the allocation of earnings to policies has run somewhat ahead of the actual position. That is a natural feature of the smoothing process and implies that at some stage the opposite needs to occur.
>
> 11. For example, following the experience in 1990, 1991 was an essentially 'neutral' year in that earnings were allocated at about the actual level. Thereafter there were two years where actual earnings were ahead of the returns allocated so that by 31.12.93 a position of balance had again been restored. That is, taking the 4 years 1990–93 together, actual and allocated earnings were in balance.
>
> 12. The negative actual return in 1994 has led to another period where allocated earnings have run ahead of the actual position. A natural reaction to a relatively high actual return for 1995 would be to allocate less than the actual earnings, so beginning the process of bringing actual and allocated returns back into line over the current smoothing period. Confirming the current roll-up rate of 10% for the year would seem to be an appropriate starting point and that would have the benefit of avoiding a discontinuity across the year end."

The prospects ahead of 1995 would depend on investment prospects. The actual financial position is reviewed in chapter 6. But at this stage the Board was again informed in general terms that there had been over-allocation. The information was still inadequate to inform the Board of the implications in terms of actual claims experience and values. Discussion in terms of percentages did not disclose the extent to which policy proceeds had been inflated by distribution practice.

118. On 20 December 1995, a total return of 7½% was regarded as most likely for the with-profits fund. The minutes recorded discussion of the need to cut bonus rates in response to such an outturn. In relation to the Society's competitive position it was stated:

> "It was noted that the degree of any constraints on free assets was influenced by the level of assets in zero or low income-producing equities, though partially offset by some higher yielding assets. There was confirmation that the Society's investment mix was much in line with the industry, which did not, however, make easy the selling of group-pensions business against a competitor who has a very high proportion in equities."

[16] (104% x 3.5) + 4% – 7.64%

There was little to indicate in-depth examination of the issues. The nature of the discussion on bonuses was not recorded.

119. Headdon prepared a report for the board meeting on 24 January 1996. He reported that the overall return was higher than expected, at 16.2%. It was suggested that maintenance of the declared rates, when others were reducing their rates, would be a useful vindication of the strategy over the last decade. There was a discussion of the valuation basis, aimed at explaining the movement in free asset ratios. The reduction in yields over 1995 was reported, and the Board had information on the impact on the valuation resulting from the use of a lower running yield. The total value was about £700m higher than would have been the case had the 1994 valuation basis continued to be applied. A provision of £50m had been included for mis-selling liabilities arising from the PIA transfer/opt out review. The view was that that sum was likely to be very substantially in excess of the actual amount of compensation. Free assets had increased over the 1994 level. The report stated:

> "12. The November paper reminded the Board that, as a result of building-up policy values at 10% in 1994 when earnings were negative, there is a gap between 'allocated' and 'actual' earnings. A year of relatively good performance, such as 1995, provides an opportunity to move towards bringing allocated and actual earnings back into balance. The natural consequence of smoothing will, therefore, be to allocate less than was earned in respect of 1995.
>
> 13. In November, it was suggested that confirming the current roll-up rate of 10% for 1995 was a sensible starting point. Unless views of future investment prospects are very pessimistic, there seems no good reason to move away from that. A reduction in the roll-up rate might also be difficult to justify in a year of relatively buoyant investment conditions. Accordingly, confirming the current 10% roll-up rate for 1995 is recommended."

Competitive considerations were then discussed. 10% was recommended as the on-going rate for 1996.

120. On 24 January, the Board approved the proposals in Headdon's report. He informed the Board that liabilities would be £100m lower than forecast and that free assets would be increased to about £1 billion. There was discussion of the implicit item for future profits. Ranson explained the background to the figure, and that the amount used was well below the total available. An on-going rate of 10% was agreed for 1996 "with its small cost for maturing policies". But the Board decided that the position should be kept under review and reconsidered early in 1996. By this stage the actuaries' advice was being challenged.

121. The valuation and declaration were dealt with at the special meeting of the Board on 14 February 1996. There were questions and discussion about competitors' likely positions. Ranson indicated that while there were a variety of features behind the Society's percentage, high free asset ratios were not in general a sign of successful companies. The impact of a great and sudden increase in new business on the Society would be significant, but the Society was not exposed to that risk. Further information was promised for an early board meeting. The Board "after due consideration" approved the recommendations.

122. At this time, there was an increase in liabilities reflecting an unanticipated increase in the rate of claims under individual and personal pensions associated with the successful marketing of the Society's managed pension contract. The year also saw accelerating growth in new business. There were implications for solvency. The possibility of raising subordinated loans was discussed in the autumn. The liability valuation was weakened. New business was being written on a revised contract that did not include the 3½% investment roll-up rate of return. This was a successful year in investment, but there were signs of stress in the liabilities side of the balance sheet. There was a growing appreciation that mis-selling liabilities could be a material factor.

123. Maintaining declared rates gave the Society a competitive advantage over other offices that were reducing their rates. The Board was assured again that final bonus was only paid on contractual claims, and no entitlement was conferred until then. Building up the sum over the duration of a policy was treated as "a useful discipline".

124. In his report to members in the 1995 accounts, the president celebrated the Society's continued success. He said that it was an essential tenet of the Society's mutuality that each generation of policyholders should be treated fairly and receive a return fully reflecting the investment conditions experienced over the period of the relevant contract. There should be no deliberate holding back of profits from one generation to the next. This principle was paramount in the consideration of bonuses to be declared in each year. For 1995 the directors decided to maintain the bonus rates at the same levels as those declared for 1994, there being no justification on investment grounds to reduce them. That was said to be in contrast to some competitors, who had decreased bonus rates for the current year.

125. Some relief was provided by the results of 1995. The results are summarised in table 4.7 below. Net assets grew from £13.5 billion to £16.6 billion representing total annual net asset growth of 23%. Premium income (net of reassurances) grew from £2 billion in 1994 to £2.4 billion in 1995, representing annual growth of 15%. Premium income included £1.6 billion relating to new business of which £1.3 billion was written as single premium business[17]. Investment income received for the year was £1.1 billion. The investment yield achieved was 5.0%. The investment return achieved by the Society on its with-profits business was 16.6%. This reflected a disclosed unrealised gain on investments of £1.1 billion. Consequently excess reserves of £530m were transferred to the fund for future appropriations from the profit and loss account. The transfer reserved the un-appropriated surplus for the year.

Table 4.7: abridged 1995 balance sheet

	1994 £m	**1995 £m**
Total investments	13,196.1	16,239.9
Current assets	566.4	527.0
Total assets	13,762.5	16,766.9
Current liabilities	217.5	154.6
Net assets	**13,545.0**	**16,612.3**
Technical provisions	12,371.3	14,907.1
Fund for future appropriations	1,173.7	1,705.2
Total fund value	**13,545.0**	**16,612.3**
Fund for future appropriations:		
- Opening balance	1,963.9	1,173.7
- Transfer (to) from the P&L account	(790.2)	530.0
- Exchange gain (loss) on retranslation	-	1.5
- Closing balance	**1,173.7**	**1,705.2**

126. The Society ended the year with investments, stated at market value, of £16.2 billion and a net asset value of £16.6 billion. Technical provisions of £14.9 billion and a fund for future appropriations of £1.7 billion represented these net assets. Consequently as at 31 December 1995 the Society had £1.7 billion in un-appropriated reserves, which represented solvency ratio of 11%[18]. Reversionary

[17] See financial tables, tables B.4 and C.4.
[18] See financial tables, table C.4.

bonus levels were retained at 4% at a total cost of £417m. Revenue yields dropped from 5.6% to 5%. On a required return of 10%, an income shortfall of 5% arose. A call on capital appreciation was required. But there remained excess appreciation of 6.6% available to contribute to the losses suffered in 1994.

1996

127. On 28 February 1996, Ranson presented a visual demonstration of the interaction between free asset ratio as shown on form 9 of the regulatory return and the movement in new business levels. The minute recorded:

> "It was not surprising that with the Society's steady but significant new business growth over many years and with its full distribution policy, the level of free assets was relatively low in percentage terms. Additionally, RHR demonstrated the smoothing of the volatile returns over the 30 years 1964 – 1994 for the with-profit funds and also that there were negative returns in only 3 of those years."

128. At the same meeting, Headdon presented a paper on the "best estimate" revenue projections for 1996 to 1998. The approach was said to provide a "relatively passive benchmark against which the future can be assessed, rather than an active target for management". The actual results for 1995 had shown payments to policyholders considerably in excess of those projected for the year. The explanation tendered was that there had been an unexpectedly high level of retirements under individual and personal pensions, associated with the marketing of the Society's new managed pension contract:

> "It appears that some clients were delaying retirement until the managed pension contract became available. A substantial part of retirement proceeds will, in fact, have been left with the Society and contributed to the premium income position..."

The consequences of the managed pension for policyholders was to become a significant factor in the closing years of the reference period. Evidence from the independent financial adviser sector indicates that some at least of its practitioners appreciated that it was to the advantage of their clients to take benefits at a time when policy values were high relative to underlying assets.

129. Looking to the future, Headdon forecast the position at 31 December 1996 on a range of hypotheses. The most likely outcome was cover of the required minimum margin of about 2x and a return on the with-profits fund of 7%. Under that scenario "free assets would... be about 2/3 of the level at the end of 1995". In the event the ratio of the fund for future appropriation to the long-term business fund fell from its 1995 level of 12½% to 11%. The board minutes recorded discussion of the report. It encouraged a relatively passive approach to investment policy on actuarial grounds. At the next board meeting, on 27 March, there was an update on the PIA transfer/opt-out review. It was thought that the Society's liability for compensation would not exceed £10m. On 24 April it was reported that there had been an accelerated rate of growth of new business. Headdon commented on the implications for solvency. However, yields were increasing, and that would result in a higher valuation rate of interest and increased free assets.

130. On 23 October 1996, there were two items that had a potential bearing on distribution policy. Ranson commented on the availability of subordinated loans. The context was not disclosed in the minute, but it was recorded that some directors believed that over time simple capital structures had proved beneficial. The comment suggested hesitation on the part of the Board. Headdon gave a report on revenue to September. Payments to policyholders in respect of pension retirements were higher than forecast and 25% up on the same period in the previous year. He had made a change in the valuation basis at September to take advantage of the highest discount rate allowed.

131. At the board meeting on 18 December 1996, a report from Headdon was considered and his recommendations approved. In relation to general business, he rehearsed the Society's bonus systems in general and familiar terms. Compounding of the guaranteed investment return and the declared bonus had applied at 31 December 1995. He stated:

> "6. For several years there has been an approach of relating the return represented by the guaranteed roll-up together with the declared bonus broadly to the prevailing yields on gilt-edged securities. The rationale for that is that such a return is the minimum a with-profits policyholder might expect. The benefits of investing more widely are passed on by way of final bonus."

This was the established position. He said that since the mid 1980s, gilt yields had declined significantly, and all offices had reduced declared bonuses. Gilt yields over 1996 had not varied much. There seemed to be no grounds for not maintaining the previous year's level. Stability in declared rates would be welcomed by policyholders and was likely to compare favourably with many other offices.

132. During the year there had been a change in policy form for new business. He stated:

> "9. During the year the major classes of business were revised to remove the 3½% p.a. guarantee implicit in the old contract terms... That change brings our contracts into line with market practice, makes them easier for clients to understand, and will give more flexibility in the management of the business if we experience a sustained period of low investment returns. It is intended, at least in current conditions, that the rate of build-up of guaranteed benefits should be similar between the old and new series contracts. Maintenance of the 4% declared rate for the old series contracts would, therefore, imply a 7½% declared rate for the new series contracts."

This policy was consistent with practice in relation to other classes of business that had been written without guarantees, as mentioned in paragraph 41 above.

133. Headdon stated that a total roll-up rate of 10% was justified by earnings, and that it would be difficult to justify a lower rate. Looking ahead, he said that there was likely to be a sustained period of low inflation and low nominal returns. In such conditions maintaining a rate of 10% would be unsustainable. A change should be initiated, reducing the on-going rate to 9%. There was no reference back to 1994. He anticipated that 1996 would be a year of "only marginal outperformance relative to the rate of build-up of policy benefits". There was a strong case for maintaining declared rates at the 1995 level. There were grounds for confirming the 10% roll-up rate for 1996. But it was appropriate to slow the rate of build-up of policy benefits forward to 9% for 1997. His recommendations were accepted.

134. On 22 January 1997, Ranson and Headdon reported to the Board on the valuation. The report contained familiar paragraphs on the Society's position and on the approach to valuation. The December report had said there were no grounds for changing declared rates. Other offices had reduced rates. If the Society maintained its rates, that would vindicate its earlier policies. Despite earnings of 10.7% 'free' assets were relatively unchanged. Reduced yields meant lower discount rates in valuing liabilities. The liabilities were around £350m higher than they would have been on the 1995 basis. There was an implicit provision for mis-selling liabilities of around £50m. In DTI terms free assets had fallen. The 10% allocation rate was recommended. For 1997, a 9% rate would be appropriate. Competitive considerations were explored. The Society's position was unlikely to be worsened by the approach proposed. The reasoning in the report had been anticipated in December. For the rest, the report repeated material with which the Board must now have been familiar.

135. At the board meeting, Headdon commented briefly on the report. He said that, based on more recent figures, it appeared that free assets would exceed £1 billion. There was discussion of the mis-selling provision. The issue was whether a change

to the provision was appropriate or whether to maintain the provision at the level and in the manner used in the 1994 and 1995 valuations. Ranson agreed to give further consideration to this issue before finalising the valuation figures. The report was approved.

136. The formal valuation and declaration meeting was held on 12 February 1997. The valuation report provided information on Ranson's approach to accounting:

> "3. ... Essentially, the Companies Act presentation is a realistic 'going concern' one designed, as with other companies, to give a 'true and fair' picture of the current position. By comparison, the DTI presentation is a deliberately cautious one whose prime aim is to ensure solvency. Accordingly, the Companies Act presentation will typically place a higher value on the assets and a lower value on the liabilities than will the DTI presentation. The Society makes use of a 'future profits' implicit item in the DTI presentation to bring the value of assets therein up to the same level as in the 'true and fair' Companies Act presentation.
>
> 4. The Companies Act presentation can be regarded as the commercially realistic one and it is on the office valuation within that presentation that the bonus decisions are based..."

The decision on the treatment of mis-selling compensation was implemented: the £50m implicit provision was removed from the long-term fund and £15m was substituted. As discussed in chapter 6, the office valuation was the basis of bonus decisions by actuarial management. It is not possible to understand the reference to that as a valuation 'within' the Companies Act presentation.

137. In relation to final bonus the report included what had become an established formula in these reports:

> "Directors will recall that final bonus is paid on contractual terminations such as retirement, maturity or death. The amount of final bonus paid is not guaranteed in advance and represents a final share of profits which can only be determined at the point of termination. It is, however, a useful discipline to build-up the entitlements steadily through the life-time of the policy and show that build-up to policyholders. The approach does not, however, confer any entitlement until the point of contractual termination is reached and the amounts of final bonus build-up before that point could be adjusted retrospectively at any time."

On that basis, Ranson recommended a 10% allocation for gross recurrent single premium contracts and comparable rates for other classes of business for 1996 and as anticipated in his earlier report a reduced rate forward for 1997 of 9%. The recommendations were approved. The minutes stated:

> "The expected slight reduction in 'free' assets in 1996 over 1995 in the DTI returns, as well as the fall in those assets as a percentage of non-linked liabilities were noted. The absorbing of substantial quantities of new business without a greater fall was seen as a strong point. The award of an AA rating by Standard & Poor was an appropriate recognition of that strength.
>
> Any decision to obtain a subordinated loan would enhance the free asset position; that might be possible before publication of the DTI returns at the mid-year point."

138. The minute recorded the reduction in the mis-selling provision from £50m to £15m. The change in accounting treatment from including the amount in long-term liabilities to treating it as an explicit provision would be taken up by the audit Committee and discussed with the auditors.

139. In his statement to members in the 1996 annual report, the president highlighted three achievements for the Society during the year:

> "Our new U.K, annual premium income, at over £400m, broke all previous records for the industry.
>
> Our total new premium income exceeded £2 billion for the first time, and included our highest ever single premiums at £1.59bn.
>
> Our expense ratio fell, for the eighth consecutive year, to the remarkably low level of 4.3%. We confidently expect this figure yet again to be the lowest in the industry.
>
> These achievements, together with many others over the years show that a well run mutual organisation can consistently produce outstanding performance."

In discussing mutuality, the president stated that throughout the Society's history it had tried to ensure that each generation of with-profits policyholder received the returns it had deserved on its investment with the Society. He said that the Society's distributions had been full and fair – "i.e. 'equitable.'" Consequently the Society did not build up surplus assets in order to boost its 'free assets' and as a result its 'free asset ratio' was inevitably, and, in his view rightly, lower than those of its competitors. This attribute was regarded by the Society as a reflection of its full distribution policy and not an indication of financial weakness. The Standard and Poor's rating was relied upon as support for the Society's strength. The directors considered it appropriate to maintain declared bonus rates for 1996 at the same level as that declared in the prior year.

Table 4.8: abridged 1996 balance sheet

	1995 £m	1996 £m
Total investments	16,239.9	18,931.2
Current assets	527.0	515.1
Total assets	16,766.9	19,446.3
Current liabilities	154.6	137.5
Net assets	**16,612.3**	**19,308.8**
Technical provisions	14,907.1	17,575.8
Fund for future appropriations	1,705.2	1,733.0
Total fund value	**16,612.3**	**19,308.8**
Fund for future appropriations:		
- Opening balance	1,173.7	1,705.2
- Transfer (to) from the P&L account	530.0	32.1
- Exchange gain (loss) on retranslation	1.5	(4.3)
- Closing balance	**1,705.2**	**1,733.0**

140. The Society's financial position is summarized in table 4.8. Net assets growth, from £16.6 billion to £19.3 billion, represented total annual net asset growth of 16%. Premium income (net of reassurances) grew from £2.4 billion in 1995 to £2.8 billion in 1996, representing annual growth of 20%. Premium income included £2 billion relating to new business of which £1.6 billion was written as single premium business. Investment income received for the year was £1.4 billion (1995 - £1.1 billion). The investment yield achieved was 5.6%. The investment return achieved by the Society on its with-profits business was 10.7%. This reflected a disclosed unrealised gain on investments of £374m. Excess reserves of £32m were transferred to the fund for future appropriations from profit and loss account. This reserved the un-appropriated surplus for the year.[19]

[19] See financial tables, tables B.4 and C.4.

141. The Society ended the year with investments, at market value, of £18.9 billion and a net asset value of £19.3 billion. Technical provisions of £17.6 billion and a fund for future appropriations of £1.7 billion represented these net assets. Consequently as at 31 December 1996 the Society had £1.7 billion in un-appropriated reserves, which represented a solvency ratio of 10%. There was further surplus capital appreciation of 1% available towards the 1994 deficit.

1997 and the end of the Ranson era

142. The general tenor of the reports to the Board during 1997 and 1998 is of some importance given the differential terminal bonus policy then in operation, and the implications for the relationships between executive and non-executive directors of the Society of the communications between them. In his oral report to the Board on 22 January 1997 Ranson dealt with the PIA transfer/opt-out review. It was intimated that at a recent meeting PIA had expressed concerns and intended to conduct further investigations. There was an investment report, monthly statistics report and other routine reports on marketing. In relation to the valuation for 1996, the issue of the £50m implicit provision for mis-selling was reviewed. There was discussion of the raising of subordinated loans. There was discussion of the financial position and the impact of subordinated debt on solvency. Ranson also recommended that the Society should take subordinated loan capital when it was in a strong position, as he said it was at the time, rather than when it might be forced to do so. Agreement in principle was given.

143. On 12 February, the Board dealt with the 1996 declaration as already noted. The treatment of the mis-selling liability was carried forward. On 26 February, the PIA investigation and the provision for compensation were discussed. Peter Wilmot, as compliance officer, was asked to make a presentation the following month. Headdon reported the projections for 1997 to 1999 in similar terms to the previous year. There was a report on investment objectives and strategy. The Society's record, of a 1% out-performance of its equity holdings over gilts, was worse than the 'intuitive' expectation of a level of 2 to 3%. The general manager responsible for investments reported that insufficient exposure to UK equities and the disappointing recent performance of overseas securities (in sterling terms) were the main reasons for the shortfall. There were no radical decisions on investment strategy.

144. The minutes of the meeting on 26 March 1997 recorded discussion of the Society's investment performance as published in a survey of ethical trusts. Equitable had come bottom of twenty funds reviewed. Some directors appeared to have been influenced by the implicit criticism of the Society's investment policies. In discussion, the validity of the comparison was challenged. On the PIA review, there was information about the cases dealt with and outstanding. There was no reference to the presentation expected from Wilmot. He did, however, report that there had been an investigation by the IMRO enforcement committee that had resulted in a personal warning to one of the Society's fund managers. Investment policy was discussed in relation to investments in companies of which members of the Board were directors. The need for care was recognised. The report and accounts for 1996 were discussed, but without reference to the resolution of the provision for mis-selling compensation referred to above..

145. On 23 April, a director commented on the minutes of the previous meeting. This somewhat singular event was provoked by the absence of any minute of Wilmot's presentation on the PIA investigation. Ranson presented a further report on the investigation and continuing difficulties with PIA. The Society intended to take legal advice on certain matters, including the extent of the duty of care. Peter Martin was invited to become involved in the discussions with the Society's solicitors. There had been a letter from PIA setting a deadline for completion of the review. The earlier complacency about the PIA investigation had apparently been disturbed to a degree. There were reports on recurring issues of investment, business statistics and marketing. Headdon reported on the first three months' operations. Premium income and investment income were close to forecast. Equity income was reduced, but 1996

was said to have reflected special dividends. Payments to policyholders were significantly increased, but that reflected common distortions in the first quarter. He had changed the valuation basis:

> "... to take account of the highest discount rate allowed under the relevant regulations, resulting in 'free assets' of £1,171m representing 8.1% of the with-profits reserves, compared with 7.6% at 31 December 1996. The solvency position remained satisfactory..."

146. There was further discussion of subordinated loans:

> "There was discussion of the proposed subordinated loans and in particular queries were raised as to the reasons for seeking loans of the amounts and in the currencies set out in the paper and on the effective loan periods proposed. Questions were asked regarding any currency risks inherent in the proposed loans and whether better terms would be available on such a loan raised in sterling in the UK.
>
> It was agreed than an analysis should be prepared setting out the options and the risks involved and the investment aspect, which could then be considered by the Board or a sub-committee."

147. On 23 May 1997, Ranson reported further developments in the mis-selling review. The Economic Secretary to the Treasury was reported to have addressed a meeting. There was reference to the pressure being generated for settlement 'at any price'. He had told DTI of his concerns about the possible impact of over-compensation on policyholders' expectations, and the concern which that would give DTI if it occurred. He reported his discussions with the Society's solicitors. The minutes recorded:

> "Directors discussed the many strands of the investigation and the way PIA are developing their requirements with a clear indication that 'goal-posts' are being moved over time. Certain directors considered that the Board would be failing in its duty if the subject was not considered in rather more detail at Board level. This was regarded as giving proper additional help to the management in its stance."

Providing help to management was an expression adopted to justify Board interest in what were regarded as matters for management.

148. Subordinated loans were discussed:

> "There was a general feeling of unease about the particular route previously decided although it was confirmed that the raising of a subordinated loan of up to £300m would be welcomed. Some directors passed comments about currency and cost aspects of the loans as proposed which they regarded as imposing unsatisfactory risks in the future and expressed a preference for a sterling loan, possibly through one banker. Various ways forward were considered and it was concluded that:
>
> > i) implementation of the raising of the loan by the two current potential providers should be halted pending review...;
> >
> > ii) the options should be considered at a meeting of the Investment Committee with the previous decision being revisited;
> >
> > iii) there was a case for some speed in case investment markets moved in a way to cause solvency to come under pressure."

The minutes suggested that the policy driver was solvency rather than pure investment freedom. However, this was an important initiative by the Board, reflecting an assertiveness not much in evidence in previous minutes.

149. On 25 June the Board approved the recommendation of the audit committee that senior counsel's opinion be sought in relation to the PIA review. It was suggested that policyholders should be informed of the Society's position regarding

the review at an appropriate time. Other business was treated in a routine fashion, apart from the subordinated loan. The proposals of the investment committee were considered. The loan amount was increased to £350m, a step "now possible in view of the Society's increased solvency margin". The directors were to receive copies of the loan documentation.

150. On 23 July 1997 the minutes of the main Board meeting recorded that counsel supported the PIA view of its power to define 'execution only' business, the crux of the Society's problem. It was recorded that:

> "... the Society intended to respond to PIA, agreeing to re-open relevant cases and to treat them as having been advised by the Society unless the client confirmed that this was not the case. ... AGT [Alan Tritton] reported that consideration had been given to whether any change needed to be made to the implicit provision of £50m in respect of possible compensation payments and that it had been agreed that no change was at present necessary."

It was reported that any additional compensation would have had no significant effect on the accounts. However, in the light of counsel's opinion the Board had now been compelled to take the PIA review seriously and to re-open its files on possible claims.

151. Ranson reported that the subordinated loan issue was going well. The IMRO visit had gone well. Investment, business and marketing issues were reported. The impact of the abolition of the right to recover tax credits on dividends proposed in the July 1997 Budget on solvency was reported and discussed. It was expected that free assets would be reduced by approximately £500m. Ranson commented that he was not recommending any changes in bonus rates. But he commented that more emphasis should be given to the sale of linked products. The Board agreed, subject to some concern about timing given the then high level of the markets. Implicit in the recommendation must have been a degree of apprehension for the future of the with-profits fund, but no reason for Ranson's views was recorded.

152. The subordinated loan issue was discussed and recorded at length. The issue had been launched on 18 July on the eurobond market with possible sales in the US. Section 68 approval would be sought to use the loan in calculating the Society's solvency margin. Approval of detailed aspects of the transaction was delegated to a committee.

153. The minutes record wide-ranging topics of report and discussion. Topics relating to sums of relatively low and relatively high value. But there was remarkable silence on the operation of policy on policy proceeds: the differential terminal bonus policy was not discussed at board meetings, so far as my investigations have uncovered.

154. The minutes also recorded that Ranson was to retire on 31 July and be replaced by Nash. An era was ending. The brief new era that followed was to see a considerable change in approach to distribution. It was also to see the emergence of annuity guarantee issue, the Hyman litigation, and the failure to sell the Society and its ultimate closure to new business.

CHAPTER 5: THROUGH CRISIS AND CLOSURE, 1997-2001

A New Era

1. Ranson's retirement at the end of July 1997 brought to an end an era in the history of the Society. He had been a significant force in the actuarial department from 1972, and a dominant force from 1982. A senior board member expressed mock incredulity that he had actually left the Society. Although witnesses were reticent, and the evidence available to the inquiry is not conclusive, it appears that the final period before his retirement, which had been considerably delayed, was not a happy period for the Board.

2. Nash reported on 24 September as managing director. Schroders were to assist the Society in avoiding approaches that would threaten mutuality. (The appointment of advisers to advise on a defensive strategy appears to have been a contentious issue for the Board prior to Ranson's retirement, with the latter arguing that news of such an appointment might appear to indicate a readiness to consider a merger or takeover, and might therefore invite predatory interest.) Good progress was being made with the PIA review. It was reported that the £50m provision "might need review". There were various reports on common items. Headdon reported on statutory solvency. Further calculations had confirmed that the combined effects of the recent change in the tax treatment of dividends and the issue of the subordinated debt left the free assets at the level they would have been at had neither event taken place. There was discussion of the steps that might be taken in the event of adverse investment conditions.

3. A report from Headdon on bonus policy was considered at the September meeting. It stated that the rates forward had been set in the expectation of low inflation. In fact the markets had been buoyant to date. He said that in the light of the expected out-turn on the sterling with-profits fund, it was appropriate to ask whether current final bonus rates would be confirmed as the actual rates for 1997 and, if not, whether the rate should be adjusted. He said that on an investment return of 15%, 9% allocation would be low. The position was even stronger on with profits business in other currencies. He recommended that the sterling rates should go up to 10% from 1 October 1997, reverting to 9% from 1 January 1998. He said that in the face of more dramatic changes in investment conditions the Board should be reviewing final bonus rates in any event. The Board instructed Headdon to report further on solvency and the action that could be taken in response to adverse investment conditions. His report was noted and his recommendations on the final bonus rate approved.

4. The Board met again on 26 November. There was a report on the progress of the PIA review, and the problems of completing agreements on redress of policyholders' claims. The audit committee report included comments by the chairman, Alan Tritton:

> "In particular he mentioned the intention of giving further consideration to identifying the risks run by the Society, both operational and business risks, and the management of them."

A meeting had been arranged with management to consider the matter further[1]. Nash commented on the favourable report on the Society by Standard & Poor's, which had marketing potential. There was discussion of mutuality. There was discussion of topics for a proposed "strategy meeting".

5. Headdon reported on the first six months' results. The discussion of his paper was recorded. The paper represented another initiative in the actuaries' thinking. It reviewed the Board policy, and policyholders' reasonable expectations as understood by Headdon. He rehearsed the financial background in 1996. He dealt with the

[1] The issue was not novel. There had been a similar initiative by the audit committee in 1996.

position in 1997. By 30 September the sterling with-profits fund was earning over 18% and long-term gilt yields were 6.2%. Final bonuses had been adjusted from 1 October 1997 to revert to the growth rates applied in 1996. Since then investor confidence had weakened, earnings had fallen to 13.5% and gilt yields had risen to 6.7%. Anticipating the outcome for the year was difficult. The market had been volatile. The range assumed was 10 to 15%. He proceeded to discuss declared rates. The reference rate had changed:

> "16. For the new series of UK pension contracts introduced on 1 July 1996 there is no minimum guaranteed accumulation rate. That means that for those contracts the rate of guaranteed growth allocated is simply the declared bonus rate. For 1996 that rate was 7.5% p.a. For older contracts incorporating a minimum guaranteed growth rate of 3½% p.a., the declared bonus rate was 4% p.a. to achieve a similar level of guaranteed growth."

For simplicity the rest of his comments were framed in terms of the new, zero-growth pensions business.

6. He stated that declared bonuses for 1996 had been based on a 7½% return, which was well above current gilt yields. The usual approach would be to reduce to 6½%. That would be consistent with policyholders' reasonable expectations. And solvency considerations indicated a reduction. The possibility of adverse public reaction was no longer a disincentive to cutting rates. It was necessary to keep the declared and total returns in proportion. There was no certainty that equities would continue to outperform. In a stable equity market with returns of 2 to 3% above gilt yields the gilt benchmark would lead to too high a proportion of consolidated returns. It would be prudent to begin adjusting expectations that declared rates would always be linked to the prevailing gilt yield. Accordingly he recommended that declared rates should be based on 6½%, and that the Society's literature should reflect less emphasis on the linkage of declared rates to gilt yields to adjust expectations. What had characterised the 'return to basics' approach was to be abandoned, and policyholders' reasonable expectations were to be managed accordingly.

7. Headdon proceeded to discuss total returns over the period 1986 to 1996 as tabulated. He said:

> "23. By December 1989 allocated and actual earnings were broadly in balance. With hindsight there then followed a 4 year cycle in 1990-93. Allocated earnings were significantly above the negative actual return on 1990. 1991 was a 'neutral' year in that earnings were allocated at about the actual level. In both 1992 and 1993 actual earnings were above the level allocated so that by 31 December 1993 a position of balance had again been restored."

8. He said that the comment above that 1990-93 was seen to be a cycle <u>with hindsight</u> was important. During that period there had been no way of knowing how conditions would evolve and how long the cycle would last. Rather judgment had to be used to steer what appeared to be the most appropriate course in the light of knowledge and views at that time. He said that another cycle was effectively entered in 1994.

> "The natural consequence of the smoothing process was that allocated earnings once again moved significantly ahead of the actual position."

There had been some redressing of the balance in 1995. 1996 was another "neutral" year. That implied that "further years in which allocated earnings are below actual returns" were needed. He said that although the volatile returns of recent years had led to heavier smoothing than normal, the whole industry had taken a similar approach. A pure smoothing approach required to be tempered by PRE. Policyholder confidence had to be maintained. He stated:

> "29. Combining these considerations the conclusion is that the allocated return should be less than actual earnings but that the margin between the two should not be allowed to get too large..."

He set out some practical examples for ranges of rates of return.

9. At the board meeting, Headdon introduced a proposed new earnings-related bonus benchmark system to replace the existing approach of basing the level of declared bonuses on prevailing gilt rates regardless of the total return actually achieved. He said that the gilt-based benchmark resulted in "theoretical" earnings significantly above the negative actual returns being achieved in years such as 1990 and 1994. The revised approach required allocated earnings to be less than actual earnings with a marginal difference between the two. There could be reasons for moving away from tracking gilt yields. There was general support for reducing declared rates. A number of directors indicated the need for a cautious approach in respect of total returns. This was a total departure from the 'return to basics' approach of his predecessor. The papers available for the November meeting were detailed and focused. The discussion indicated a developing change of relationship between the Board and management.

10. On 17 December the audit committee report covered the PIA review, and there was reference to the change in the regulatory structure with the transfer of responsibility for the supervision of life offices from DTI to the Treasury from 5 January 1998. The Economic Secretary to the Treasury would thereafter have responsibility for both the pensions review and the prudential supervision of life offices. It was noted that prudential supervision involved responsibility to safeguard the reasonable expectations of policyholders. The managing director made a lengthy report on new business, the form and presentation of figures, systems and consultancy, mutuality and cost and management control. There were reports on investment, and business statistics. The investment committee had been presented with information on the statutory solvency position, including a solvency matrix showing the effect of changes in the value of equities and the yield on fixed interest securities. It was agreed that Headdon would make a presentation to the next board meeting on this material. There was a report from Headdon on the need to introduce a separate annual financial condition report. The Board agreed to "enhance" the current form of reporting instead. The Board discussed bonus and Headdon's recommendations were agreed.

11. The valuation report was presented to the Board on 28 January 1998. Headdon compared the regulatory return and statutory accounts bases of accounting. Of the Society's approach, he said:

> "5. The Society has taken the approach of always setting the mathematical reserves at a level such that no separate resilience reserve was required. It was felt that that approach gave less information away about the precise strength of the valuation basis and avoided giving the impression that reserves had been set at the minimum possible level. Recent changes to the content of the DTI returns do, however, mean that a knowledgeable observer can now make a good assessment of how the basis relates to the regulatory minimum."

A number of offices routinely included explicit resilience reserves without comment.

12. He then described the approach to valuing recurrent single premium business:

> "6. For recurrent single premium business such as that sold by the Society, the full current claim value of a policy, excluding final bonus, can be regarded as the starting point in any consideration of the appropriate reserve. In the absence of regulatory considerations that could be regarded as the 'natural' level of reserves since it simply represents the premiums paid and declared bonus additions accumulated on the same assumptions as the contract terms on which policies were sold. In fact, as a regulatory test, it is quite a conservative valuation method because, in most cases, it will be several years

before the policyholder has any entitlement to receive the current policy value, except in the event of death.

7. Up to and including the 1989 valuation the Society took a passive approach of reserving the full current claim value, excluding final bonus, on recurrent single premium contracts with a comparable approach to other types of business. Such an approach is known as a 'premium basis' valuation. Following the negative returns of 1990 and subsequent more volatile conditions, a more active approach has been taken of changing the valuation basis each year to reflect then current conditions. In practice this has meant reserves somewhat lower than if the 'premium basis' approach had continued to be used. For example, at 31 December 1996 the mathematical reserves for non-linked contracts were 95% of what they would have been on the 'premium basis'.

8. In setting the basis for the 31 December 1997 valuation I have encountered a new situation. The decline in yields over the year, together with the removal of tax credits on UK dividend income, means that, if I maintain the approach of selecting a basis such that no explicit resilience reserve is required, the reserves will be higher than on the 'premium basis'. That is, for recurrent single premium policies, the reserves held would be greater than the amount payable, excluding final bonus, if all such policies became claims on the valuation date."

Headdon said that this showed how stringent the regulatory requirements were. He advised that the Society should show the premium basis, and the resilience reserve, and demonstrate to the regulator the need to review the resilience provisions. Apart from a somewhat didactic approach to the regulator, the actuary had effectively acknowledged that between 1989 and 1996 the Society had not applied the premium basis of valuation, but had reduced liabilities and, therefore, increased surplus, by understating the natural value of the single premium business. In PRE terms, the assumption had to be that the policyholder would have expected the immediate consequence of investing with the Society to have been a loss of value.

13. Headdon reviewed the results. In November he had recommended a 1% cut in the main pensions rate. There had been two developments since that reinforced his view: yields had declined and other offices were cutting rates. There had been some discussion in November of a greater cut, but Headdon took the view that investor confidence could be damaged by a greater cut. His recommendation remained the same. He discussed media interest in the abandonment of declared bonuses, but was generally opposed to that for existing business. The Society had in hand a new managed pension contract that would not carry declared bonuses. He set out the valuation data. On the results, the growth rate should be increased from the October level of 10% to 12% or 13%. 12% would mean a loss of competitive position. 13% would maintain the existing position. He recommended 13%.

14. Headdon outlined this analysis again at the meeting. His proposals to meet the requirements of GAD were approved. His declared bonus recommendations were approved, as were his recommendations on total return. Other issues at the January board meeting included the PIA mis-selling review. It was said that the Society had been making good progress. The president reported that the audit committee had formally considered the appointed actuary's recommendation on the level of provision for compensation for mis-selling. A provision of £75m at 31 December 1997 was approved. Nash made a report covering a range of management issues. There was a marketing report, and a report on statistics. Headdon commented on the solvency matrix and notes.

15. The final valuation and bonus report was presented on 17 February 1998. Headdon reported on the differences between the statutory and regulatory accounts. He illustrated the financial effect of a declared bonus rate based on 6½% for the current series of personal pensions and individual and group pension schemes, bringing out the value of the fund for future appropriation on the statutory basis

and the solvency margin on the regulatory basis. He discussed final bonus rates, and recommended a total allocation rate of 13% for recurrent single premium business and comparable rates for other business. Foreign business was dealt with separately. He recommended that directors should expressly reserve the right to reconsider final bonus rates at any time.

16. The minutes of the meeting of 17 February reported that Headdon had addressed the meeting and answered questions. The cut in declared rates was said to be consistent with other offices and was unlikely to attract adverse criticism. The increase in final bonus rates would help maintain competitiveness but would be unlikely to improve it significantly. Policyholders would be likely to be pleased.

17. The review of the board minutes disclosed nothing to suggest an unusual degree of apprehension about the Society's financial position. The reports for the second half of the year had changed in character. But there was a reticence about issues of real significance. Policyholders' reasonable expectations were discussed. But it remained the position that there need not be any reserves for future terminal bonus. The differential terminal bonus policy was in force. But its implications were not mentioned, and the risks it might present were not identified, even though the audit committee had shown an interest in risk assessment and management.

18. In relation to liability valuation and bonus allocation, 1996 and 1997 appear, with hindsight, to have been years of calm before the impending storm of protest. There was considerable vigour in the Board's approach to the conduct of business, starting before Ranson's retirement, but accelerating after he had gone.

Table 5.1: abridged 1997 balance sheet

	1996 £m	**1997 £m**
Total investments	18,931.2	23,620.8
Current assets	515.1	582.3
Total assets	19,446.3	24,203.1
Subordinated liabilities	0.0	346.4
Current liabilities	137.5	176.1
Net assets	**19,308.8**	**23,680.6**
Technical provisions	17,575.8	21,504.3
Fund for future appropriations	1,733.0	2,176.3
Total fund value	**19,308.8**	**23,680.6**
Fund for future appropriations:		
- Opening balance	1,705.2	1,733.0
- Transfer (to) from the P&L account	32.1	446.7
- Exchange gain (loss) on retranslation	(4.3)	(3.4)
- Closing balance	**1,733.0**	**2,176.3**

19. 1997 was a year of excellent investment returns, though the Society's equity returns did not materially out-perform gilts. Sclater's statement to members in the 1997 Companies Act accounts continued the celebratory theme. There was record growth in new business. The fund for future appropriations was increased by excess capital appreciation of £447m. Mis-selling liabilities were discussed at length. The financial position is summarised in table 5.1 above. Net assets growth from £19.3 billion to £23.7 billion represented total annual net asset growth of 23%. Premium income (net of reassurances) grew from £2.8 billion in 1996 to £3.5 billion in 1997 representing annual growth of 22%. Premium income included £2.4 billion relating to new business of which £1.9 billion was written as single premium business. Investment income received for the year was £1.3 billion. The investment yield

achieved for the year was 5.0%. The investment return of 17.2% achieved by the Society on its with-profits business reflected by a disclosed unrealised gain on investments of £2 billion. Excess reserves of £447m were transferred to the fund for future appropriations from the profit and loss account. This reserved the un-appropriate surplus for the year[2].

20. The Society ended the year with investments, stated at market value, of £23.6 billion and a net asset value of £23.7 billion. Technical provisions of £21.5 billion and a fund for future appropriations of £2.2 billion represented these net assets. The effect of the above was that as at 31 December 1997 the Society had £2.2 billion in un-appropriated reserves, which represented a solvency ratio of 10%.

21. The investment return of 17.2% earned on the with-profits fund was reported as an excellent real return that compared favorably with the results of many other diversified funds. The Board decided to increase the total rate of return allocated to policyholders, however reduced the declared bonus rate element of this to reflect the lower future returns expected if low inflation rates were to be maintained. During the year the Society secured additional capital on what it regarded as advantageous terms by issuing approximately £350m of subordinated guaranteed bonds through its wholly owned subsidiary, Equitable Life Finance plc. This form of financing was reported by the Society as having been used by a number of other mutuals and was said to have become an accepted part of financial management of mutuals.

1998

22. The discussion in January 1998 had been informative, even if much of it was repetitive. There had been an exposition of the "passive" approach to reserving up to 1989, and the "more active approach" adopted from 1990 in response to the negative returns of that years and subsequent more volatile conditions was discussed. The "new situation" at 31 December 1997 was explained and the advantages of the new approach were rehearsed.

23. On 25 March the minutes of committees were presented. Nash presented the managing director's report. He commented on the, now persistent, high level of retirements under pension policies, which he said had been inflated by pre-Budget rumours. He reported on expenses. He discussed the PIA review. He reported that the Society had been selected by *The Times* to participate in the newspaper's 'Top 100 Companies Initiative', which would involve the development of study materials and case studies for schools. Schroders had agreed to assist if there were any form of offer for the Society. There was an investment report, reports on monthly statistics and marketing, and matters of special interest.

24. Headdon reported on a meeting with the pensions schemes office of the Inland Revenue regarding the failure of the Society to apply for tax approval for certain individual pension schemes in 1991 and 1992. The pensions schemes office had indicated that they would give approval for the schemes with effect from April 1997 and that they would deal with settlement of outstanding tax liabilities and interest without the clients being aware of the error. He said that the settlement was unlikely to exceed £3.5m. There is no record of any reaction by the Board.

25. The meeting of 22 April received a range of reports. Nash referred to a recent exercise by NPI in raising capital in the market by means of what was effectively financial reinsurance. The reaction had not been particularly favourable: there had been adverse publicity in the press, and it seemed likely that the costs would be high. But it was another means open to mutuals to raise capital if required. A fresh seed had been sown. A table of 25-year endowment proceeds had placed the Society last. He had protested that a number of offices had declined to take part "apparently leaving the Society at the bottom". Nash complained that other offices had inflated their results artificially. He had written to the journalist.

[2] See financial tables, tables B.4 and C.4.

26. On investment, it was reported that the Society was investing 60% of new money in fixed interest securities and 40% in equities as a matter of caution. There was a report on manpower. The field force had reduced in numbers. There was a strategy to stabilise the size of the force. Headdon gave a presentation on the capital requirements of writing certain classes of business. A note was circulated proposing an approach to capital management. The financing of unit-linked and with-profits business was discussed. The capital providing function of with-profits business was discussed. Headdon's conclusions were:

> "(i) there are general commercial arguments in favour of a slightly more balanced mix of linked and with profits business.
>
> (ii) The Society's low charges mean that the capital requirements of linked business are relatively low. It can be attractive to get additional linked business that would not otherwise be obtained.
>
> (iii) For single premium business the linked product is generally more attractive than the with profits version in capital terms. If it was desired to change the balance of linked and with profits business within existing sales volumes, single premium products would be a technically attractive area on which to focus.
>
> (iv) Careful attention to with profits product features can have a significant effect on capital requirements. This is being given active attention and a number of helpful changes have already been made.
>
> (v) Care need to be taken not to adopt marketing approaches which encourage the substitution of linked business for long-term with profits business since that would threaten the Society's capital base."

27. On 22 May there was further reference to the NPI financing arrangements. A paper was to be prepared. Investment strategy was discussed. Nash had had a meeting with the welfare reform Minister following his offer of assistance with the design and pricing of stakeholder pensions. Other reports were presented and noted. The development of business in Dubai was approved. The annual general meeting of the Society was held the same day. On 24 June there was discussion of points that had been raised at the AGM. There was a proposal that there should be a newsletter, and various views were advanced. The outcome was that:

> "It was accepted that some improvements to the current, relatively limited communication with policyholders could be made, and it was agreed that the Managing Director and Actuary and his senior colleagues would develop that."

The audit committee report was presented. Tritton commented on the directors' overall responsibility for the regulatory returns and the obligations they had to make certain certifications as part of the return. He commented that it was appropriate for the Board to approve the signature of the returns.

28. Nash presented a report. He discussed new business, expenses, the provision of consultancy services, training, and PIA supervision. There were several other routine reports. There was discussion of strategy. International business was discussed. It was decided it should be limited until the United Kingdom market became saturated. Nash wanted to concentrate on developing the UK market, though he said that Guernsey was important and should be developed. NPI's new form of finance was discussed again. The Board was advised to keep a watching brief on developments.

29. The Board next met on 22 July. Nash reported at length as managing director. There were routine monthly reports. The marketing report covered a range of new products. Final bonus rates were discussed. As recommended in a note from Headdon dated 16 July reporting strong market growth, it was agreed that:

> "(i) if markets continued at around current levels, it would be appropriate to make some increases to final bonus rates,

(ii) the Directors present at the Investment Committee on 12 August 1998 be authorised, if appropriate, to agree increased rates of final bonus to apply from 1 September 1998,

(iii) any revised rates introduced from 1 September 1998 should be ratified by the full Board at the normal September meeting."

On 21 August the directors were sent copies of minutes and other papers for information. There was no meeting of the Board in August. The secretary advised that no special comments need be made on the current reports; the Society's progress would be reviewed in the usual way at the next Board meeting in September.

The GAR crisis breaks

30. However, the Board's interests were about to change direction. On 28 August, Headdon distributed an internal memo to staff on the emerging guaranteed annuity issue[3]. On 1 September, he sent a confidential memo to the non-executive directors. He enclosed a copy of the staff memo, and gave examples of the operation of the differential terminal bonus policy. Having emerged, the GAR issue was to become a primary pre-occupation of the Board. There was a meeting of executives on 7 September to discuss the annuity guarantee issue. On 9 September there was a briefing meeting at which the differential terminal bonus issue was discussed. The cost of meeting the guarantees was estimated at £1.5 billion[4]. Markets were volatile, and solvency was an issue. Making increased use of implicit profits adjustment, changing investment policy in favour of gilts, increasing the subordinated loan, and the possibility of passing the declaration were discussed. The atmosphere had changed. The annuity guarantee problem and its implications for the Society's financial position dominated board discussions for the rest of the year.

31. The minutes of the meeting on 23 September set out a lengthy discussion on the guaranteed annuity rates issue. Headdon gave a summary of the background to the business sold to and after 1 July 1988. He outlined the treatment that had been applied, and justified it on the grounds of equity and said that the policy had first been applied in respect of 1993. He repeated his estimate of the cost of meeting the guarantees at £1.5 billion. The current intention was to provide for a liability of £100m in the accounts. Headdon commented on the solvency position in the light of market volatility and on the steps the Society might take, including making more use of implicit items, changing investment strategy in favour of gilts, increasing the subordinated loan, or passing the bonus declaration. The discussion was followed by an investment report in usual form, commenting on market opportunities and recent investment in equities, and proceeded to deal with other recurrent items of business.

32. The next board meeting was on 28 October. The guaranteed annuity issue dominated the managing director's report. Nash commented that it had always been made clear that the final bonus was not guaranteed, and that it would be open to the directors to reduce the rate of final bonus for the future. At the same meeting there was comment on the Standard & Poor's AA rating, the PIA mis-selling investigation, and the preparation of an updated history of the Society. Thereafter the general monthly business proceeded.

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[3] See chapter 1 paragraphs 13 to 42.

[4] In the course of maxwellisation, Headdon and Ranson in particular have objected to the use of the expression 'cost' in this context. 'Cost' was the expression used in the minutes of the meeting of 9 September 1998 and repeatedly thereafter. It appears to me to be a convenient description of a liability recognised as arising from a contractual provision not previously priced and taken into account. The capital deficiency that arose was funded by withholding seven months' return to policyholders. The 'cost' was met in that way.

33. There was a meeting on 11 November 1998 involving some of the non-executive directors to review the guaranteed annuity position. The meeting discussed the reserving position in anticipation of a meeting with the Treasury and GAD. Headdon proposed a reserve of £200m, but thought that the cost was unlikely to exceed £50m in current financial conditions. At the board meeting on 25 November, Nash discussed the progress of the guaranteed annuity issue. The usual recurrent items were then dealt with. The Board then had a preliminary discussion on the 1998 declaration. The issue was effectively shelved to the December meeting.

34. On 9 December there was a further meeting between management and selected non-executive directors. Preparations were in hand for litigation. Headdon reported that regulators had asked for further information on the question of policyholders' reasonable expectations. On reserving it was reported that the official view was that it was necessary to have regard to the contract terms and to reserve for the whole of the primary benefit under each contract. The primary benefit in individual pension and group pension contracts was a cash benefit, with the guaranteed annuity a secondary benefit. In those cases the primary benefit had to be reserved in full, and a prudent provision made for the option, but not necessarily on the basis of full take-up. However, the retirement annuity contracts were, in GAD's view, written with an annuity as the primary benefit, and full reserving was required for the guarantees. The Society had argued strongly that the distinction was illogical. The minutes make clear that the Society's actuaries had now had a firm statement of the official position on the application of the regulations to the Society's retirement annuity business.

35. At the meeting on 16 December 1998, there was further discussion of the guaranteed annuity issue. Nash presented a wide-ranging report on the Society's financial position and options. A minute of the meeting on 9 December was circulated. He reported on the current position. The proposal to initiate declaratory litigation was discussed. Matters were put in hand to prepare for the annual general meeting, which was expected to be difficult. There was reference to further legal advice on the reserving issue. Counsel were said to be firmly of the view that the directors did have the discretion on terminal bonus that they claimed. However, in order to meet some of the regulatory pressure on levels of reserving, the possibility of financial reinsurance was investigated, to take the liability off balance sheet if GAD did not change its mind. And the investment committee was considering means of easing the solvency position. There were also discussions with the Society's auditors on the presentation of figures.

36. Nash's report gave information on the major changes in the guaranteed provisions in contracts in recent years. He said that removing guarantees would have a significant cumulative effect over time. But the benefit would be slow to emerge since only new business was affected. He said:

> "Looking for opportunities to make further beneficial changes of this type is now a regular feature of product reviews between the actuarial and marketing areas."

Management's policy was made plain: the removal of guarantees with the "beneficial" effect of reducing reserving requirements was well established. The meeting proceeded to other business. The PIA review was discussed. Investment, business statistics and marketing reports were presented. And the bonus declaration was discussed. In relation to bonus generally, the recommendations were approved. The minute of the December meeting indicates a full appreciation of the significance of the terminal bonus issue affecting GARs. The actuary reported that the "special calculation" for GAR cases had first been introduced at the 1993 declaration. There was no reference to a board decision on the topic.

37. In respect of bonus, some directors wished for a further reduction in declared rates on the basis of falling gilt yields and the effect on investment freedom and potential returns where greater guaranteed benefits were provided. The sensitive nature of such a reduction was recognised, including the risk that it could weaken

policyholder confidence in the Society. The bonus issue was carried forward to the January meeting. In the actuary's report of 27 January 1999 reserving was discussed in relation to particular factors rather than generally. The report dealt with reserving for GARs.

38. The Board discussed the 1998 valuation. Headdon's paper was long and complex. Under reference to general approach, he advised that the resilience reserve would have to be higher, having regard to the financial conditions during 1998. The nominal level of valuation factors had to be changed to keep within regulatory limits. Mis-selling compensation provisions were increased to £70m after taking account of sums already paid out to policyholders. There had been changes of approach by PIA/FSA that had increased the number of cases qualifying for compensation and the quantification of loss. GAR experience was narrated. He said that the £50m at risk did not require to be revised. Reserving issues were discussed in terms of regulatory and statutory criteria. The guaranteed annuity liabilities would be dealt with differently in the statutory and regulatory accounts. In the light of industry comparatives he based his valuation on a declared bonus rate for the year of 5%.

39. The draft regulatory valuation brought out available asset values sufficient to meet solvency requirements on the more stringent test, allowing £1.45 billion for the GAR liability and taking account of implicit profits of £850m, which was less than half the full amount available and within the permitted limit of 5/6 of the RMM[5]. Cover would be raised to twice the minimum margin if the full amount of £1.9 billion were counted. Having ensured that the RMM was met on the basis of the 5/6 limit, Headdon said that he had sought permission from Treasury to bring the full amount into account in the returns. But he noted that there would be PR risks associated with such a dramatic increase in the future profits included. The picture that emerged was of an office far less strong than the actuary would have wished, even at the level of market values pertaining.

40. Headdon turned to terminal bonus. He said that actual earnings had turned out higher than anticipated. Volatility in the markets and the threat of recession required caution. But he recommended an increase from the roll up rate of 9% to 10% total return, reverting to 9% for the ongoing rate into 1999. A market comparison was carried out. 10% would give pay-outs that compared well with other offices. He recommended that rate.

41. On 27 January 1999 Nash reported on public relations matters relating to the guaranteed annuity issue. He told the Board that the declaratory action had been started earlier than expected to avoid solicitors acting for the action group from being able to issue a writ. He reported on the reserving implications arising from the guaranteed annuities. He reported on the investigations that had been undertaken in connection with financial reinsurance arrangements. ERC Francona had offered reinsurance at a modest premium of £150,000 per annum plus a loading on claims that would remove about £1 billion from the reserving requirements based on GAD guidance. If that arrangement did not meet with GAD approval, Cologne Re had offered reinsurance at an annual premium of £20m to £30m. The contrast between the two offers did not generate discussion, so far as disclosed by the minutes.

42. With the exception of the developing GAR issue, and despite the technicality of the report, the total bonus issue was unexciting. Reserves had been set up on the same basis as 1997, at a level that essentially represented the full value of guaranteed benefits with, in the regulatory returns, an additional resilience reserve. The £70m provision for mis-selling compensation was approved, £45m having already been paid out. Headdon recommended a declared rate of 5%, and this was approved. The Board went on to discuss cost management and control, and the arrangements for the annual general meeting.

43. The final report on bonus was presented to the Board on 24 February 1999. The recommendations were approved. There was no change in thinking. The

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[5] See chapter 7 for an explanation of the term 'full amount' and the 5/6 limit.

statement of bonuses appended set out the Board's approach in some detail. Note B7 contained the differential terminal bonus proposition. Nash reported on the position of the litigation. Headdon reported on the reinsurance arrangements on offer. Contingency planning for failure in the *Hyman* litigation began with a note from Nash. At the meeting, Tritton presented the report of the audit committee. Tritton said:

> "The Committee had considered the disclosures which would be necessary regarding guaranteed annuity rates in the Society's Report and Accounts. He reported that the commercial cost of meeting guarantees was not currently expected to exceed £50m. The Audit Committee had been advised that it was intended to show a reserve of £350m in the Report and Accounts. This figure was based on very conservative assumptions and was supported by the Society's auditors. The reserve to be shown in the Society's statutory returns to HM Treasury, based on the recent guidance issues by the Government Actuary, would be approximately £800m. The basis of reserving required by HM Treasury was excessively prudent, in the Society's opinion. It was recognised that a clear explanation of the difference between these three amounts would be required. The committee had considered whether a contingent liability in respect of guaranteed annuity rates arose and required disclosure in the Report and Accounts; it had concluded that in the light of the strong legal opinion that the Society would be successful in its legal action, no such contingent liability needed to be disclosed."

44. Apart from the developing guaranteed annuity issue, 1998 would have been seen as a good year for the Society. Investments income was high, and represented a satisfactory yield, reflecting general market trends. Net asset value grew substantially, including £1.7 billion of reported capital appreciation. Aggregate earnings of 13.3% were sufficient to meet the total allotment of 10%, represented as comprising a 3½% roll-up rate, a reversionary bonus of 1½% and a terminal bonus of 5%, and to leave a 3.3% earnings residual. The total bonus allotment of 10% was met by a call on available capital appreciation. The unallocated excess of 3.3% was available as a contribution towards the over-distribution of 1994, but not sufficient to cancel it completely.

45. In his annual statement to members, the president reported:

> "I usually start my statement with a few indicators of our success, and this year is no exception.
>
> - Total premium income in the year was again a record at £3.7bn, some 8% higher than in 1997. Premiums from our international business represented £197m of the total, being an increase of 18% over 1997.
> - Total new premium income for the year was a record at £2.6bn, although 1998 saw a greater emphasis on single premium business than in some recent years.
> - The market value of our assets stood at over £28bn at the end of 1998.
> - Our expense ratio (that is the ratio of our expenses of management to our total premium income) fell for the 10th consecutive year to 4.0%, which we again expect to be the lowest in the industry.
> - The overall return earned on the with-profits fund during the year was 13.3%."

He reported that in view of lower yields generally available on investments, which were considered likely to continue, the directors had concluded that the rates of declared bonus should be reduced. This approach was said to be in line with most other life offices.

46. Annuity guarantees were discussed in the statement. However, Sclater endeavoured to present the progress of business as normal in other respects:

"1998 was an unusual year for The Equitable. Over the last few months of the year we received unfavourable publicity over guaranteed annuity rates.... The Equitable has generally enjoyed favourable press comment, and to be the subject of criticism has caused many of our members, your Board and our staff great concern – particularly as the Society's approach stems from its principle of treating all of its members in a scrupulously fair and correct way.

The controversy over guaranteed annuity rates does not, however, overshadow what has been another successful year in the Society's long history."

47. The financial position at the end of the year as presented is summarized in table 5.2 below. The Society's net assets grew from £23.7 billion to £28.1 billion, representing total annual net asset growth of 19%. Premium income (net of reassurances) grew from £3.5 billion in 1997 to £3.7 billion in 1998 representing annual growth of 8%. Premium income included £2.6 billion (1997: £2.4 billion) relating to new business and of this, £2.2 billion was written as single premium business. Investment income for the year was £1.8 billion. The investment yield achieved for the year was 4.5%. The investment return achieved by the Society on its with-profits business was 13.3%. This reflected a disclosed unrealised gain on investments of £1.7 billion. Excess reserves of £849m were transferred to the fund for future appropriations from profit and loss account. This reserved the un-appropriate surplus for the year. [6]

48. The Society ended the year with investments at market value of £28 billion and a net asset value of £28.1 billion. Technical provisions of £25 billion and a fund for future appropriations of £3 billion represented these net assets. Consequently as at 31 December 1998 the Society had £3 billion in un-appropriated reserves, which represented a solvency ratio of 12%. In 1998, the published data showed that the fund had returned broadly to balance. Declared bonus was reduced to reflect reduced yield.

Table 5.2: abridged 1998 balance sheet

	1997 £m	1998 £m
Total investments	23,620.8	28,015.7
Current assets	582.3	629.8
Total assets	24,203.1	28,645.5
Subordinated liabilities	346.4	346.2
Current liabilities	176.1	226.0
Net assets	**23,680.6**	**28,073.3**
Technical provisions	21,504.3	25,048.0
Fund for future appropriations	2,176.3	3,025.3
Total fund value	**23,680.6**	**28,073.3**
Fund for future appropriations:		
- Opening balance	1,733.0	2,176,3
- Transfer (to) from the P&L account	446.7	849.2
- Exchange gain (loss) on retranslation	(3.4)	(0.2)
- Closing balance	**2,176.3**	**3,025.3**

1999

49. 1999 was another year of good returns. But it was dominated by the guaranteed annuity issue. Having disposed of the 1998 valuation in January and February, the Board turned to the developing situation in 1999 at the meeting on 24

[6] See financial tables, tables B.4 and C.4.

March. There were reports on the current litigation. The recurring business was reported and dealt with. The annual accounts were approved for signature. Headdon reported on solvency which was to be a recurrent issue. He reported that various measures already taken had reduced the scope for coping with future adverse conditions. The Society remained sharply exposed to deteriorations in financial conditions. That exposure was one of the key risks facing the Society. He set out the remaining options: raising further subordinated debt capital; the use of implicit future profits items; and financial reinsurance. He discussed the enforcement of policy conditions to restrict the growth of guaranteed annuity liabilities. He discussed product design. The Board was advised of the cost of financing the annuity guarantees by hedging and by liability matching. The Board was now engaged in a major damage-limitation exercise.

50. There was a further meeting on 30 March to discuss the regulatory return which had been required early, preventing the usual course of prior discussion by the audit committee. The cover of the minimum solvency margin had been increased by greater use of the future profits implicit item than previously. He said the liabilities valuation had dealt with the guaranteed annuity issue in line with the guidance of the Government Actuary (at £1.6 billion), and the effect of the reinsurance treaty was shown (an off-set of £810m). Schroders made a presentation on the regulatory issues relating to the use of equity derivatives in the with-profits fund.

51. On 29 April, recurrent business was dealt with. Headdon discussed projections of the financial position. He expected the Society's financial position to improve after 1999. On 19 May the litigation was discussed. Other business was routine. There was comment on the annual general meeting that had preceded the board meeting. A number of members had commented unfavourably on the Society's communications with clients. Advice was to be taken. On 9 June the only business noted was related to telephone instructions by policyholders and the need for a 'paperless direct debit' indemnity. On 23 June there was a report on the progress in the litigation. Tritton and Wilson resigned. Arrangements were made for nomination of new non-executive directors and it was recommended that Headdon be appointed a director. That was duly implemented. Compared to the high level of activity over the second half of 1997 and the first half of 1998, business had become routine and unimaginative under the influence of the *Hyman* litigation.

52. At the board meeting on 28 July, the litigation was reported. There was a discussion of regulatory investigations. Nash expressed dissatisfaction with the approach of PIA, seeking to assess past sales practices against standards set subsequently in their guidance. He had written to the authority. There had been IMRO investigations, and Nash was dissatisfied that errors were still happening in the Society's procedures. Directors emphasised the need to keep regulators satisfied. In the investment report there was reference to the increase in gilt yields, and the decline in the general price level of UK equities. Sales were being affected by the *Hyman* litigation. Investment policy was discussed.

53. By the next board meeting on 22 September, the outcome of the *Hyman* case at first instance was known. Directors were told that there was likely to be an appeal. The risk of a predatory bid had been recognised, and a board committee had been set up to deal with any approach. There was discussion of guaranteed annuity rates involving Schroders and Cardew & Co, the Society's PR consultants. The minutes suggest more enthusiastic treatment of the normal recurring business than had been the case of late.

54. On 27 October business appeared to have returned to normal. The cost of hedging the guaranteed liabilities had been found to be unjustified. There was a report by the audit committee that dealt with a revised approach to risk management, internal audit and compliance. Ernst & Young were to assist the Society in the introduction of a revised risk management system and internal controls. Nash presented the managing director's report. The PIA review continued.

The Society's liabilities for compensation for mis-selling were likely to increase from £60m to £100m in respect of phase 2 of the review. There were extensive reports on subsidiary companies, on sales and on revenue.

55. Having succeeded in the first instance hearing, there was a high level of confidence that the Court of Appeal would support the Society's position. Bonus planning late in the year was dealt with in that light. Headdon advised maintaining declared rates and increasing final rates in view of investment experience.

56. On 24 November there was a report on the preparations for the Court of Appeal hearing. The Society's legal team were said to remain confident of success. The managing director's report dealt with recurring items such as expenses and new business. In addition he dealt with proposals for amendment of the articles of association. The Board's focus was firmly on the future. Public relations, new non-executive directors, and forward business planning were discussed. Headdon reported on the forthcoming bonus declaration. His report followed the usual pattern for the November paper, setting the context, reminding directors of the system, commenting on policyholders' reasonable expectations, discussing the economic and financial background, and then dealing with bonus rates. The 1998 rates were rehearsed. They had involved a significant reduction from the 1987 rates. He said:

> "The Society made a significant reduction in declared rates last year, the rates for 1997 having been based on 6.5% p.a. Although rates based on 5% p.a. are probably too high in the medium term in a climate of inflation around 2.5% p.a., there would seem to be good reasons for leaving rates unchanged this year. In particular:
>
> (i) The movements in yields on gilt and fixed interest stocks this year do not lend much support to the logic for a further cut in rates.
>
> (ii) We have reduced declared rates quite sharply in recent years with a particularly large reduction last year. A year now without change would be consistent with the expectation we have given of some stability in the level of declared rates."

The declaration was seen as having important public relations implications. He said that he would not recommend on that basis if such a course of action were injudicious on financial grounds. But the previous year's reduction had put the Society in a position where maintenance of the rates would be likely to be recommended in any event. There were compelling reasons to take that course. The Board agreed.

57. The total roll-up of policy values was at that stage at 9%. Headdon analysed the relationship between the return available and the growth rates allocated from 1989 to 1998. He repeated the assertion that at 1989 allocated and actual earnings were broadly in balance. He said that there was again a position of balance at the end of 1993, and that asset values were only a little behind policy values at 31 December 1998[7]. He continued:

> "26. The overall position must, however, also be considered from the viewpoint of individual policyholders. All policyholders joining the fund since 31 December 1994 will have seen allocated returns below available earnings in every year for which their policies have been in force. For those entering in 1995 with a 5 year contract that will have been for the whole policy term unless the position is reversed for 1999. Thus, for those policyholders, there are strong grounds to allocate a little more than has been earned in 1999 if the smoothing process is to be seen as having real meaning."

Equitable was said to have been more cautious than the average office. His tentative views depended on earnings. At the Board Headdon went over the argument. The Board agreed with his approach. The observations on the respective positions of

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[7] See chapter 6 for an analysis of the financial position.

different cohorts of policyholders were significant, given the general emphasis on fund values as the basis for policy decisions.

58. At the December Board the result of the Court of Appeal hearing had not been announced. There was a report on the proceedings. There were the usual recurring items of business. There were reports on investment prospects. There were discussions of bonus based on the November paper. But it appears that the Board were awaiting the outcome of the case. On 21 January 2000 the Court of Appeal delivered judgment against the Society. Headdon distributed a brief note in which he made the "firm recommendation" that current final bonus rates be maintained. The Board met that day. Leave to appeal had been granted. The Court of Appeal had agreed that meantime the Society could continue with its current approach to bonuses. Counsel's advice was that the decision could be attacked. Headdon's advice on final bonus was accepted, though it was recognised that if the Society lost in the House of Lords recovery of overpayments would not in practice be possible.

59. The Board met again on 26 January. Nash reported. Amendment of the articles of association was discussed. There were the usual monthly reports.

60. Headdon reported on the valuation and bonus declaration. His report had been prepared before the Court's judgment. It was extensive. It covered the general approach to valuation. He reported that 'full value' reserves had been established with additional resilience reserves. That represented a markedly higher level of reserves than had been necessary in earlier periods. There was an explicit reserve for annuity guarantees, on a prudent commercial basis in the statutory accounts, and in the regulatory returns a higher reserve based on regulatory guidance, offset by the reinsurance arrangement. There was reference to improved mortality among annuitants. He had strengthened the valuation to reflect the trend. He did not inform the Board whether he had applied the latest mortality tables fully. He set out the latest estimate of mis-selling compensation, and discussed the changes in the FSA/PIA approach. The provision was increased to £132m. The provision for annuity guarantees in the statutory accounts was discussed, and he recommended that the existing provision of £200m should stand. He recommended that the declared bonus should be based on 5%, and that, given the return for the year, final bonus should be based on a 12% growth rate for 1999, with a 9% rate forward for 2000.

61. At the meeting, Headdon reminded the Board that the Court of Appeal had indicated that the Society could continue with its current bonus approach. The Board would be asked formally to approve rates in February. For the February meeting the January reports was re-presented with minor alterations. The recommendations were accepted.

62. There had been a decline in premium income in 1999 of 7%. The annuity guarantee controversy had affected the business. However, net assets had continued to grow, assisted by a high level of capital appreciation. The fund for future appropriations was increased by £1.8 billion. The president reported to members that the Society had achieved a relatively high return on investments. In relation to bonus he said:

> "We have taken a disciplined approach to declared bonus levels in recent years and we were able to maintain our rates of declared bonus at last year's levels – for example, 5% p.a. for the current pension products. We increased the overall rate of return allotted to policies for 1999 to 12% p.a. for pension business and to 10.25% p.a. for life business, which is subject to a different tax regime.
>
> I believe our bonus rates provide competitive policy results over a wide range and duration of policies and it is clear from our standing in surveys conducted by financial publications that this view is shared by objective commentators. At the heart of this performance is our commitment to the fair and full distribution of profits that is central to our approach to mutuality."

He looked to a future in which the Society would continue to be committed to providing innovative, high-quality and value-for-money products, supported by excellent service and delivered through the channels that the Society's clients found most practical and convenient. These included web site and direct telephone sales channels. The accounting provision for the guaranteed annuity issue was maintained at £200m, which was said to be a prudent provision for any additional liabilities that might arise through clients choosing to exercise guaranteed annuity rights under their policies. It was a balanced, if somewhat unexciting, assessment of the current and immediately past two years.

63. The Society's year-end financial position is summarised in table 5.3 below. During 1999 net assets grew from £28.1 billion to £32.9 billion, representing total annual net asset growth of 17%. Premium income (net of reassurances) fell from £3.7 billion in 1998 to £3.5 billion in 1999 representing an annual decline of 7%. Premium income included £2.3 billion relating to new business and of which nearly £2 billion was written as single premium business. Investment income for the year was just under £2 billion. The investment yield achieved for the year was 3.9%. The investment return achieved reflected a disclosed unrealised gain on investments of £2.3 billion. Excess reserves of £1.8 billion were transferred to the fund for future appropriations from the profit and loss account. This reserved the un-appropriate surplus for the year.[8]

64. The Society ended the year with investments, stated at market value, and a net asset value of £32.9 billion. Technical provisions of £28.1 billion and a fund for future appropriations of £4.8 billion represented these net assets. Consequently as at 31 December 1999 the Society had £4.8 billion in un-appropriated reserves, which represented a solvency ratio of 17%.

Table 5.3: abridged 1999 balance sheet

	1998 £m	1999 £m
Total investments	28,015.7	32,855.8
Current assets	629.8	638.6
Total assets	28,645.5	33,494.4
Subordinated liabilities	346.2	346.2
Current liabilities	226.0	240.4
Net assets	**28,073.3**	**32,907.8**
Technical provisions	25,048.0	28,066.7
Fund for future appropriations	3,025.3	4,841.1
Total fund value	**28,073.3**	**32,907.8**
Fund for future appropriations:		
- Opening balance	2,176,3	3,025.3
- Transfer (to) from the P&L account	849.2	1,822.9
- Exchange gain (loss) on retranslation	(0.2)	(7.1)
- Closing balance	**3,025.3**	**4,841.1**

2000

65. The events of 2000 were challenging and difficult for the Board and for management. It could not have been otherwise. The mood of management and of the Board reflected changing perceptions of the Society's position and in particular the impact of progress in the *Hyman* case and of the House of Lords' decision. For the formal February meeting the actuarial reports that had been presented on 21

[8] See financial tables, tables B.4 and C.4.

January were re-presented with minor alterations. The recommendations that bonus decisions should stand notwithstanding the decision of the Court of Appeal were accepted.

66. The managing director's report for the board meeting on 23 February outlined recent progress in preparations for the House of Lords. But there were normal recurring reports on new business, finance, investment and other items. The attempt to force de-mutualisation of Standard Life caused concern that there might be a similar initiative by members of Equitable. The new stakeholder products were identified as a strong signal of the Society's commitment to the future pensions market. Progress in the PIA mis-selling review was reported. There were new initiatives by FSA in respect of transfer cases. The Board received reports in the usual form. The progress in identifying new non-executive directors was reported. The progress of the case was discussed. Standard Life's dispute with policyholders proposing demutualisation was discussed. Sales and the general market environment were discussed at some length. A fall in sales for the month as against the previous year was explained. The *Hyman* case was not mentioned as a factor. Training and personnel issues were discussed. The guaranteed annuity rates issue was said to be a factor that had made filling professional vacancies more difficult. There were reports on subsidiaries.

67. Late in February there was press speculation that Prudential intended to make an offer for Equitable. There was a meeting of executives and some directors on 1 March 2000 to discuss the issue. The chairman of Prudential had by then written to deny the report. There was general discussion of strategies relating to possible offers. It emerged that Standard Life had been advised on directors' duties in terms that differed from the advice given to Equitable by their solicitors. There was discussion of the value of the Society. Chris Jillings of Schroders, who attended the meeting as an adviser, stated that, with a payment for goodwill, there could be a sizeable sum payable to the Society's members in the event of an offer. Belief in the marketability of the Society at a premium was to develop. A range of decisions was taken on the future of the Society.

68. Nash's report for the March board meeting covered a range of issues of general management interest. Progress in the *Hyman* case was mentioned briefly. New business was reported. Marks & Spencer had decided to appoint the Society one of their AVC providers: the business had been a target the Society had strived to secure for a number of years. The Society had also been appointed AVC provider for members of the Scottish Parliament. On 14 March the Society had been awarded a trophy as "Best Personal Pension Provider" at the Consumer Finance Awards. The citation had stated:

> "Equitable Life has a formidable reputation for low charges and all-round value for money. It is, admittedly, involved with a dispute with one group of pensioners at present but regardless of the outcome it is clear that for many people saving for retirement, Equitable Life provides an unsurpassed service."

The report dealt with a typical range of issues of recurrent interest.

69. The Board met on 22 March. Nash reported on new business, along the lines of his written report, on plans for the annual general meeting, and on the proposals to amend the articles. There were typical recurrent reports on investment, business statistics, and sales and marketing. The statutory report and accounts were discussed. Headdon reported on projections of the Society's financial position. The projections on all of the longer-term scenarios shown in the report indicted an improved solvency position over the years following 2000, when the solvency ratio was predicted to be 2.2 times the minimum margin. The minute recorded:

> "CPH then commented on the reduction in the scale of claims under retirement annuity policies, which indicted that a significant number of policyholders had deferred taking benefits while the recent and current Court actions were in train. This had had an effect on the Society's new business, as

> a large proportion of funds taken at retirement was normally re-invested with the Society to purchase annuities. Once the House of Lords' judgment had been delivered, a significant increase in the level of claims under retirement annuity policies could be expected."

Headdon reported on the implications of the new stakeholder pensions provisions for the Society. Ring-fencing of the stakeholder funds raised a number of issues including constitutional, reserving and smoothing considerations.

70. Nash's report for the April Board dealt at length with preparations for the forthcoming annual general meeting and the House of Lords' case. Scenario planning for the House of Lords' hearing was advanced. There had been preparation of media and client communications. Combined with that work, preparations were in hand to deal with a hostile predatory approach. A draft embedded value calculation of the business had been carried out on the extended model office system. Work was continuing with actuarial consultants at Ernst & Young to refine the calculations. First thoughts had been given to the implications of failure in relation to "the possible need for management and other changes". At the Board on 26 April Nash presented his report. PR consultants commented that current media comment reflected a misunderstanding of the guaranteed annuity issue as it was presented by the Society, and advised that there was a need for a new approach. Nash reported that there appeared to be few 'carpetbaggers' among new business proposals. Preparations for the case were described by the solicitor. Routine reports were presented on investment, marketing and other issues. Committee membership was dealt with, and there was a decision to ratify the setting up of a new investment subsidiary.

71. Nash's report for the May board meeting was relatively low-key except in relation to mis-selling compensation. The PIA transfer/opt-out review was discussed and the PIA/FSA AVC review was anticipated. There was discussion of a forthcoming PIA monitoring visit. The Board heard brief comments on the report. Nash then reported on discussions that had taken place with Schroders about recent de-mutualisation moves at Standard Life and Friends Provident. Scottish Provident and Scottish Life were also mentioned as reviewing their status. There was a brief report on preparations for the House of Lords. At the annual general meeting questions on the guaranteed annuity issue were raised and comments made. The minute reflected a degree of heat and dispute. Activist policyholders had begun to question the Board closely.

72. In his report for the June meeting of the Board Nash referred to a summary of the proceedings at the House of Lords hearing. Preparations for an adverse outcome in which the Society had to adopt a single rate of final bonus for GAR policies and had to use as that rate the same rate as for pension policies without GARs had been put in hand. The financial, and other, implications of such a ruling both in respect of future requirements and in respect of potential compensation payments in respect of many thousands of past retirements were currently being assessed. He reported on new business, financial statistics, investments, subsidiaries and the mis-selling reviews and investigations. He reported on an initiative from the ABI aimed at improving the image of the insurance industry, particularly "in the wake of the pensions misselling scandal". There were proposals for an accreditation scheme, with a quality mark. Client communications were discussed.

73. The meeting took place on 28 June. A number of recurrent items of business occupied the first part of the meeting. Nash then brought the directors up to date on the House of Lords hearing. The solicitor reported on the hearing and the possibility that the Lords' decision might be adverse. Headdon commented on the significant financial implications for the Society. Nash added that:

> "... in this scenario, if the Society were to continue in its current form, there would be likely intervention by the FSA as well as severe restrictions on investment freedom, with adverse effects on policyholders' benefits. In consequence, in these circumstances, it was unlikely to be appropriate for the

> Society to continue in its current form as an independent mutual organisation. Serious consideration of the position would have to be given once the details of the judgment were known."

PR considerations were discussed. Other business proceeded with little recorded comment.

74. At this stage, therefore, the Board was confronted with the real risk of failure and warned of consequences that would have been unthinkable a few weeks earlier. Instead of an outright defence of mutual status, with the assistance of Schroders, directors were being asked to contemplate de-mutualisation in a context of solvency difficulties and inhibitions on investment freedom that would be detrimental to policyholder interests. On 7 July there was a board meeting. Schroders made a presentation on the work they had done in developing a defence manual for use in the event of a predator seeking to acquire the Society. However, since the possibility of an adverse judgment in the House of Lords might result in the Society being unable to continue as an independent mutual, Schroders had been asked to change direction. Financial reinsurance would lapse in the event of total failure. Solvency would be affected. They set out the options thought to be open. Schroders identified the critical issue:

> "SSSB commented that the critical issue was to consider how the goodwill value of the business could best be maintained. The Board needed to consider whether this was more likely to be achieved by pre-emptive approaches prior to judgment or by an open auction immediately after judgment.
>
> As regards valuation of the Society, SSSB were not able to assess the goodwill value and could not be confident that it would necessarily be sufficient to provide the additional capital required as a result of a Scenario 6 ruling. It would be necessary to manage carefully members' expectations regarding windfalls, as these were likely to be negligible."

Scenario 6 was close to the doomsday scenario of total failure[9]. There was lengthy discussion. It was agreed that the Board should meet in the morning of the day of the judgment, shortly after the judgment was made available to the Society. The apocalyptic tone of the minute is instructive. From over-confidence, the Board had moved to a position of near-despair.

75. On 18 July the Board met to discuss logistics for 20 July when it was expected the Lords would deliver judgment. Preliminary decisions were taken on Headdon's recommendations:

> ".. it would be necessary to adjust bonus rates for all policies containing guaranteed annuity rates. If the House of Lords' judgment was "Scenario 6" then he would be recommending that the Board should suspend final bonuses for all classes of policy from the date of judgment and that revised rates should be approved at a Board meeting to be held the following week."

He circulated a note of possible resolutions. There was then a discussion of possible resignations, of public relations, of the steps necessary to retain staff, and of preparations for a sale. Schroders had prepared a skeleton information memorandum for completion as part of the documentation that would be issued to prospective buyers. It was anticipated that there would be a competition and that the Board would need to agree the criteria for judging competing offers.

The response to *Hyman* and the sale process

76. I have commented already on the contingency planning carried out during the *Hyman* litigation. And as seen above, the prospect of total failure was confronted in

[9] See chapter 1, paragraphs 95, 112 and 113. This meeting took place after the original scenario 6 had been developed into scenarios 6 and 7. But it is not clear which version of scenario 6 was referred to.

the days before the House of Lords delivered its judgment, and initial steps were taken to prepare for that event. The sale of the Society as a going concern and a compensation scheme for policyholders who had taken benefit under the differential final bonus regime (then estimated to number approximately 35,000) were central elements of the action likely to be required. Following extensive preliminary discussion, the way forward was discussed by the Board on 20 July 2000, and it is important to note the decisions then taken in context.

77. The solicitors' reported on the judgment, and on the Society's comprehensive failure in the litigation. The Board rejected the need for resignations. The solicitors' advice was that the exercise of the directors' discretion in deciding bonus rates had to be rectified to comply with the terms of the judgment, in the future and for past retirements. That required a "benefits adjustment plan" (later referred to as the 'rectification scheme') in respect of past retirements, endorsed by an independent actuary. But there remained a risk of further litigation.

78. Headdon explained the effect on bonuses. He advised that the current reinsurance arrangements would cease in three months' time. The Society would be very close to the minimum solvency margin and that would result in severe constraints on its investment freedom. His best estimate of the cost of benefit adjustments to past retirements was between £100m and £200m. Current bonuses required to be reduced over all classes of policy. He recommended that final bonuses should be suspended from and including 20 July 2000 for all policy classes. Revised rates would be put to the Board on 26 July. For the avoidance of doubt, the suspension of final bonuses was made effective from midnight on 19 July.

79. The possibility of closing to new business was discussed, but it was said that such a course of action would result in the 'goodwill value' of the Society diminishing significantly, and that this would not be in the interests of the Society and its members. Nash confirmed that management's opinion was that the Society should make itself available for a trade sale. That was also the opinion of Schroders. The Board resolved to seek the sale of the business to an organisation capable of providing capital support and continued investment freedom. The Board further agreed that steps should be taken to ensure that members joining the Society after midnight on 19 July 2000 should not participate in any benefits derived from the sale of the business. Investment policy was reviewed in the light of the decision in *Hyman*.

80. The Board assumed that there would be a sale: the steps envisaged to exclude late joiners from any benefits that were realised reflected that confidence. I have seen no evidence that casts doubt on the good faith of the Board in this matter. The optimism proved to be unfounded, but it was real. And it formed the basis of communications with regulators who similarly believed a profitable sale to be highly likely[10].

81. The revision of bonuses that followed on 26 July was again reflective of confidence that the Society's operations would continue as before, with appropriate adjustments to bonus policy. It was decided that no growth should be allocated to policies for the first seven months of 2000, and that the previous growth rate of 9% p.a., set by the Board in February 2000, should be resumed with effect from 1 August. Policy values would not be reduced below those shown on annual statements as at 31 December 1999. The approach was intended to emphasise that just seven months' growth had been lost out of a policy term typically of several years.

82. The bonus adjustments were intended to be only temporary. Headdon recommended the declaration of a supplementary final bonus for cases maturing between 20 July 2000 and the date of the sale to give an indefeasible right to an additional element of bonus to those who would otherwise have been disadvantaged by comparison with those whose policies matured on or before 19 July 2000 and

[10] As I shall discuss in chapter 17.

with those whose policies matured after completion of the sale. The bonus should be sufficient to restore them to the pre-judgment position, but would only be paid in the event that the eventual purchaser paid an amount into the with-profits fund that was at least equal to the amount of goodwill included in the surplus. A sale of the Society was expected within twelve months, and he considered that it would be appropriate to reflect goodwill in the surplus to be divided by way of final bonus. To justify such an approach, goodwill needed to be brought into the valuation of assets and Headdon considered that that would be appropriate. Since the amount was necessarily speculative he suggested a conservative valuation of £1 billion, which was below the value of goodwill which he thought could realistically be expected to be realised.

83. The decisions taken at this stage were to have lasting consequences. In the first place the need for a rectification scheme was recognised as an absolute requirement that could be met without having regard to the actual outcome of the sale process or other potentially competing financial interests. It was seen as an inevitable consequence of the Lords' decision. That course of action was only consistent with either an unshakeable belief that the Society would be sold in a competitive process, or a complete failure to contemplate the possibility that there would not be a successful sale. The need to provide for retrospective 'top-up' of maturity values, which attracted conflicting advice from counsel, was consistent with the same approach. With the benefit of hindsight it may be seen to have reflected a degree of self-delusion, but I have to emphasise that I have found no evidence to suggest that the expectation of a sale on advantageous terms was less than genuine.

84. Nash prepared a report for the board meeting on 26 July. Its contents were un-remarkable with the exception of the now recurrent report on mis-selling investigations which tended to grow in length as compensation costs increased. On 26 July the Board were told of policyholders' mixed reactions to the House of Lords' judgment. The proposals for a sale were discussed. Consideration was being given to hedging the guaranteed annuity liabilities. Arrangements were made to take the sale process forward. In respect of final bonus, Headdon commented on Nash's report, on the problems associated with the calculation of the impact of the decision, and about the rectification plan. The paper discussed the legal constraints on the Board and the need to re-exercise discretion. He had discussed with counsel how to achieve rates that were fully consistent with the judgment. Paragraph 13 of the paper stated:

> "The division of total with profit policy values at 31 December 1999 was as follows:
>
> | | £bn |
> |---|---|
> | GAR policies | 6.7 |
> | Non-GAR policies | 20.1 |
> | | 26.8 |
>
> On the assumptions described... the GAR class will overall receive benefits worth 20% more than if no benefits were taken in GAR form. That implies that the general level of benefit needs to be reduced by 5.5%, making allowance for £200m to be paid to past retirements:
>
> | | |
> |---|---|
> | GAR policies | 7.6 |
> | Non-GAR policies | 19.0 |
> | | 26.6 |
>
> On these assumptions the total economic transfer of value to those taking benefits in GAR form (including past retirements) is £1.1bn."

85. The additional liabilities affected the whole with-profits fund, with a loss of value to the non-GAR policyholders of £1.1 billion. At the meeting, Headdon said:

> "Paragraph 13 of the paper set out the division of total with profit policy values at 31 December 1999. It went on to show the revised division, based on the assumptions... which implied that the GAR class would overall receive benefits worth 20% more than if no benefits were taken in GAR form. This implied that the general level of benefit needed to be reduced by about 5.5% making allowance for £200 million to be paid in respect of past retirements. On these assumptions the total economic transfer of value to those taking benefits in GAR form (including past retirements) was £1.1billion. The effect of new business in the first half of 2000 was to create a higher proportion of non-GAR benefits in the overall policy value split, compared with that as at 31 December 1999. In consequence, CPH considered that a reduction in policy values of around 5% should be an adequate allowance for the new treatment required to be given to GAR benefits."

He went on to discuss how this might be achieved. He proposed that no growth should be allocated for the first seven months of 2000 and that the previous growth rate of 9% should be resumed from 1 August 2000:

> "Such an approach had a number of attractions, as policy values would not be reduced below those shown on annual statements as at 31 December 1999 and the approach emphasised that just seven months' growth had been lost out of a policy term typically of several years. ... A consistent approach would be taken for policy classes with different benefit structures, such as endowment assurances. In the case of with profits annuities in payment, CPH recommended a reduction of 1% p.a. in the growth rates, bearing in mind that such policies could not be transferred, to avoid too sharp a discontinuity in income levels payable to the annuitants."

The possibility of supplementary final bonuses was discussed.

86. There was discussion whether a one-off adjustment was the appropriate course. Another issue was dealt with as follows:

> "Whether reinstatement, with effect from 1 August 2000, of a growth rate of 9% p.a. was appropriate, in the light of investment earnings thus far in 2000. CPH commented that the Society had deliberately under-distributed for a number of years, in anticipation of a year of poor investment earnings. The growth rate of 9% p.a. was set by the Board in February 2000 on the assumption that earnings during 2000 would be lower than 9%. CPH's view was that reinstatement at the level of 9% p.a. was appropriate and that the growth rate should be considered further in October 2000 in line with the Society's normal approach to such reviews."

Some directors wanted an independent actuarial review. However, Headdon's recommendations were followed.

87. The proposals for withdrawal of all growth for the first seven months of the year did not distinguish the guaranteed investment rate of growth from reversionary bonus. The illustrations of the effect of the proposals implied the withdrawal of the 3½% GIR. In his paper, Headdon set out the growth pattern on a comparative basis. At 9% roll-up a total policy value of £100 would have grown to £105.25. On his proposals it would have remained at £100 for seven months, increasing only to £103.75 at the year-end. There was no discussion of the investment rate of return. However, arithmetically, the five months' growth was just sufficient to cover 3½% for the year. The guarantee would be met implicitly, but the presentation would not expressly reflect that fact. It was not dealt with in these terms before the Board. Subsequently the rate was varied to 8%.

88. The development of the rectification scheme was discussed on 9 August 2000. Headdon also commented on the possibility of recovering from earlier policyholders

who had received too much benefit on maturity, and on the commercial and legal implications of not seeking recovery. The possible need for litigation on the proposals was discussed. The need for third-party verification was discussed. Hedging of guaranteed annuity liabilities was discussed. Schroders stated that a third party would prefer to complete the purchase of the Society with some limit to the GAR liabilities having been set. The directors agreed to establish some prudent degree of hedging. On 17 August, the Board met again. The arrangements for the sales process were discussed. Tim Roth of Ernst & Young commented on an actuarial report that the firm had in preparation. Chris Jillings of Schroders discussed the invitation letter then under preparation. The Board identified its objective as being to obtain the maximum value for the Society's members. It would also be necessary to be in a position to explain any choice, and to say why it was preferable to closing the fund to new business. The rectification scheme was again discussed. Preparation of a redundancy scheme was put in hand.

89. In preparation for the September board meeting, Nash wrote a report in common form. There was extensive discussion of regulatory investigations and the Society's current position on compensation. Endowment mortgage policies were added to the list of problem areas. The appointment of Neil Fagan of Lovells as solicitor to the Society was discussed. On 25 September Nash distributed a further report on guaranteed annuity rates for last survivor cases. He reported that the PIA Ombudsman had favoured the Society before the decision in *Hyman* in holding that the guaranteed annuity rates applied only if benefits were taken as a single life level annuity without a guaranteed period. Now the PIA Ombudsman intended to change his view in response to policyholder complaints. The Society's position had been that substituted annuities would be granted on current annuity terms. The Society had not previously offered reversionary annuities, but had been advised that it should do so. The report dealt with policyholders' reasonable expectations. It was intended to challenge the Ombudsman's approach. Nash set out possible approaches for the future. The Hyman decision had again uncovered practices and issues that were at least controversial.

90. The Board met on 27 September. A major item of business was the report of the remuneration committee on redundancy policy and severance terms. There was a division among directors whether executive directors should have the benefit of the increased benefits, in particular in the light of possible adverse press criticism. The Board approved the proposals, reserving the treatment of executive directors. The sale process was reported. Matters were said to be proceeding well, but the first round bidders were likely to be fewer than expected. Schroders briefed the Board on the process to date and on matters raised by potential bidders. Bids were due the following day and there would be a presentation by Schroders to the Board on 5 October to enable the Board to consider and compare the indicative bids. Selected bidders would then go forward to the second stage. The due diligence process would be based on documentation in a 'data room' which had been prepared, and on presentations by, and discussions with the Society's senior management. That process should be complete in around five weeks, after which bidders would be required to submit virtually complete offers, including a marked-up transaction agreement and summary scheme which they would be prepared to execute. It was planned that an announcement regarding the preferred bidder would be made in December.

91. Nash then commented on the developing implications of the guaranteed annuity rate issue in relation to surviving spouses' annuities ('subsidiary annuities' in terms of some of the documents). He and Headdon explained that the reason the issue had not been identified before was that prior to the Lords' decision the matter had not been important: the Society adjusted final bonus rates to reflect the form in which benefits were taken and no additional cost had been incurred. The minutes reflect a degree of concern about the Society's practice, but the executive recommendation to challenge the Ombudsman and stick with the recommended practice was accepted.

92. On 5 October 2000 the Board met. The sale process was reported by Schroders. Indicative bids had been received and placed before the Board. Schroders advised that the offers were not out of line with other recent, similar deals. However, a number of potential bidders had expressed concern about the guaranteed annuity rate issue and in particular the take-up rate and payment of additional contributions on guaranteed terms under the policies. For two bidders this was critical to whether they made any offer at all, not just to the price. Schroders recommended that negotiations should be taken forward with all those who had submitted indicative bids, and that the Society should assist them in understanding the annuity guarantee issue more fully. Schroders also recommended that a contingency plan should be developed to deal with the situation if none of the bidders put forward a definite proposal. The Board recognised the importance of having such a plan and Schroders were asked to advise.

93. Headdon referred to a paper on final bonus for the period. The Board was invited to make comments in advance of the formal October meeting. There was a further report on the guaranteed annuity rate issue, and reference to the fact that a policyholder had written to the chief executives of all of the bidders drawing attention to the dispute.

94. Nash's report to the Board on 25 October was in common form, with the exception of a query raised by a director about the role of Fagan, the new solicitor. Headdon's report on final bonus rates for the period 1994 to 2000 was circulated afresh. In the report he set out the re-assessment of the probable levels of bonus on the Hyman basis for each year, pointing to the artificiality of the exercise: the financial context for actual decisions would have been different had the Hyman decision been known at the time. The calculations were based initially on an analysis of contemporary yields. He allowed for future premiums and brought out a table of value adjustments for each year. He then applied take-up rate assumptions and brought out figures for adjusted policy values to complete the re-balancing exercise. He recommended levels of substituted final bonuses for each year. At the board meeting there was discussion of Fagan's role as adviser to the current Board. The sale process was discussed. Schroders offered their initial advice on the possibility that there might not be a sale. Alternative contingency measures were discussed, but the then current scheme for a total sale was considered the best option. Further advice was sought. The 2000 bonus declaration was carried forward until after the sale process, and it was noted that the rectification scheme had become embroiled in controversy[11]. Headdon's recommendations in relation to the retrospective terminal bonus allocation were discussed and approved.

95. The Board met on 8 November. It was resolved that counsel should be instructed to advise on the existence and merits of any claims the Society might have against the directors from time to time, and that a sub-committee should be appointed to review the advice and to decide on action. Only Jonathan Dawson, who had been recently appointed and had not been involved in any of the material decisions that were or became controversial, was free from conflict of interest. He was appointed a sub-committee of one. Possible conflict was recognised in the case of Fagan. But the conflict of interest involved in a sub-committee of the Board having the delegated power to decide on a course of action that might involve suing other current members of the Board for breach of duty went without comment.

96. The Board proceeded to discuss the on-going sale process. Contingency planning was carried forward. Closure to new business was acknowledged as the only alternative to sale. In this situation Schroders advised that the Board should take all actions possible to improve the solvency position, for example through the sale of parts of the Society's business and by adjusting the investment strategy. This would be a most unattractive option and would raise issues regarding public relations, staff retention and the Society's approach to surrenders and transfers of benefits. However, Schroders commented that the sale process was currently going

[11] See discussion of the 'Jeremy Lever' controversy in chapter 8.

well. If the contingency plan were needed, the information to implement it was largely available. Any work undertaken on the contingency plan should be kept very strictly confidential, as to do otherwise could have an adverse effect on the current sale process. By this stage confidence was being maintained, but with greater effort.

97. Nash's report for the November Board discussed the negotiations with the three bidders, 'Eagle', 'Panther' and 'Cougar'. That morning 'Cougar' had dropped out. Guaranteed annuity issues were discussed in respect of the subsidiary annuity issue and the rectification scheme. An issue had arisen whether the Society should be continuing to trade:

> "As requested at the board meeting held on 8.11.00. Denton Wilde Sapte with assistance from others are in the process of finalising a report on whether we should be continuing to advertise and take on new business in the light of the sale. ... The essential messages are, I understand, that continuing to trade is perfectly permissible thought some detailed textual changes are recommended to some of our advertising etc material."

Nash referred to meetings with action groups. In view of potential conflicts of interest, he had told Fagan that they wanted to drop him[12]. The rest of his report covered recurring items, and gave extensive information on the regulatory investigations. He reported that PIA had serious concerns about the sales process used by the Society in relation to managed pensions contracts. It was possible that disciplinary action would be taken by PIA.

98. Headdon presented a report on the 2000 bonus declaration. Prospective purchasers had agreed that it was sensible to postpone the declaration until completion of the sale process. The key concern was adding to the liabilities when the statutory solvency position was already thin. In respect of total allocations, he was inclined to keep the level at 9% and review the position in January. He repeated the advice that in recent years (on this occasion said to be in the last five years) the Society had allocated a rate below actual earnings.

99. The Board met on 22 November. On the sale process, Nash reported that there were two remaining potential bidders. He confirmed that contingency planning was in hand against the possibility that there would be no sale. He reported on progress with the PIA ombudsman and the rectification scheme. Instructions had been drafted to take counsel's opinion on claims against directors. There was no record of any concern about conflict. Peter Wilmot, the secretary to the Society, reported on the threatened enforcement action by PIA related to managed pensions contracts. The Board agreed that consideration of the declared bonus should be deferred, but noted the risk of adverse publicity.

100. The sale process finally failed when the last prospective bidder withdrew on 6 December. On 7 December Nash resigned. The Board met the same day for general business and it was resolved to close to new business. Nash's resignation was accepted. Headdon was appointed chief executive and actuary. It was said that FSA knew of and supported that appointment, subject to formal regulatory approval and discussion of the longer-term position regarding the joint roles. Schroders described the final stages of the sales process. The Board were advised that they had to look to maintaining assets of value. Headdon sought approval of the rectification scheme. The Board approved the scheme. Comment will be made on the rectification scheme elsewhere. At this stage it is noted that the decision to approve the scheme was taken in a very different context from that in which its preparation had been instructed, which was while the Society had been a going concern and still open to new business. The sale process had failed: but it had become clear that a solution to the guaranteed annuity rate issue was required for progress. There was no record of any material discussion of the matter at the meeting. It does not appear to have occurred to the Board that with the collapse of the sale process there was a new

[12] Lovells and Mr Fagan were subsequently appointed to advise the new Board after March 2001.

context in which it might be appropriate to deal with the whole guaranteed annuity issue as part of a single scheme.

101. Dawson reported on a consultation with counsel. Counsel had considered the points put forward, but could see no basis for the Society seeking to take legal action against present or past directors because of their failure to take legal advice regarding bonus declarations. The Society's solicitor warned that there was an increased risk of litigation by policyholders. This bizarre passage in the Board's conduct of affairs was not at an end.

102. In a circular of 12 December 2000 the president, John Sclater, outlined the position as follows:

> "In July, the Board of The Equitable announced that, as a result of the House of Lords' ruling on GARs, it had decided that it was in the best interests of members to commence a process to find a purchaser for the Society. Following that announcement, the Society received a large number of expressions of interest and received indicative proposals from three companies. The Society then held more detailed discussions with these three companies, who were invited to make firm proposals by the end of November with a view to announcing a formal offer for the Society before Christmas. No firm proposals have been received and, yesterday, the last of the parties who had submitted an indicative proposal withdrew from the process. The Society and its advisers continue to have discussions with a number of parties who have expressed an interest in acquiring some of the operations of the Society However, these discussions are of a preliminary nature. The Board has concluded that it is unlikely that these or other discussions will result in sale proceeds and/or capital support sufficient to restore the capital strength of the with profits fund."

Following the closure

103. With the closure of the Society to new business on 8 December 2000, the course of events clearly changed. Between that date and the reference date of the inquiry a number of important events took place: the sale of parts of the business of the Society, much of it to Halifax plc and the successive withholding of bonus and reductions in policy values to which I referred in my introduction not least among them. However, as I hope will be clear from this report, the real damage had long been done by then.

104. In recounting events after the closure, I have had to keep in mind my terms of reference. I am tasked to inquire into the situation of the Society as at 31 August 2001. The Economic Secretary also asked me, in her letter of 31 August 2001, to avoid disruption of the ongoing business of the Society. On an extreme view this might be construed as inhibiting the inquiry from investigating in any way the activities of the Board of Equitable after 31 March 2001. I understand that to be the view of the current board and its advisers. On the other hand, I consider that I have had a legitimate interest in ascertaining from the Board facts and circumstances that might instruct a rigorous analysis of the financial position at my reference date, and assist in formulating recommendations for the future conduct and regulation of life assurance business. This has led to conflict. Since I had no powers of compulsion, the Board has been able to refuse free access to the Society's records, and in particular Board papers, dated after 31 March 2001, and only latterly and in relation to specific requests has provided the level of co-operation I sought.

105. Bearing this in mind, I do not think that it would greatly serve my terms of reference to recount any aspects of the events of the eight months of 2001 in any great detail. The account would inevitably be patchy at best, and could be seriously misleading at worst. In this final part of the chapter I will therefore discuss a number of issues relating to the closure to new business and subsequent events which I regard as central to a true understanding of the issues on which I am

required to comment to fulfil the remit. And in the next chapter I will offer my own view of what the situation of the Society was at 31 August 2001, taking account of the financial information made available by the Society in respect of 2001.

106. Headdon reported as chief executive for the final Board meeting of the year on 20 December. Public relations had become stressful. Staff were in shock. There were mixed and changing reactions to the closure to new business. Following the failure of the sale interest had been expressed in a wide range of transactions. Headdon reported that he had asked the Society's solicitors to report on the suggestions that there should be litigation against the directors personally. He reported on continuing regulatory investigations as Nash had previously. There was an extensive report on managed pensions. Headdon reported that the proposal to be put to PIA was that the Society should send a questionnaire to all existing managed pension policyholders regarding the explanations they were given when the managed pensions were sold. PIA's concerns related primarily to the explanations given by the Society, and to the client's understanding, of the risks inherent in the contracts and to the Society's exploration and recording of the client's attitude to risk.

107. At the meeting, substantial severance payments were agreed for three outgoing directors, Bowley, Thomas and Nash. The text of a circular to policyholders intimating the 'restructuring' of the Board, involving the resignation and replacement of the existing non-executive directors was discussed. Staff were coming under pressure. There was said to be a significant outflow of funds. Treasury Select Committee and FSA internal inquiries had been announced. There was a report from Schroders on continuing sales activity. Headdon had a paper on the long-term scenarios for the Society. These included the possibility of reaching some form of settlement with guaranteed annuity policyholders which fixed their entitlements. The report had focused the need for a compromise of some kind at this stage, butthe issue had been live since SSSB's advice on 9 August 2000 of bidders' interest in a resolution of annuity guarantee liabilities[13]. In the course of negotiations, some bidders had intimated that they required such a scheme. The minute disclosed neither discussion of nor decision on the suggestion. It is one of the continuing mysteries of the approach of the Board and management over the second half of 2000 that there was no attempt to develop a scheme for settlement of the annuity guarantee claims. Had the Society taken the initiative its prospects of achieving a satisfactory sale of the business as a whole must have been improved.

108. At the meeting there was reference to the threat of further litigation. The Society was still not applying guaranteed annuity rates to subsidiary benefits except where it was clear that a representation to that effect had been made in illustrations for example. It was said that a change of policy would be expensive. Counsel had given equivocal advice on the society's position. Counsel thought that the Society could sustain the argument, but that the Court could rule against it. There was an air of concern about the course that management had been following. It appears to be clear that the decision in *Hyman* had affected confidence in management policy generally.

109. On 22 December the sale of Permanent Insurance for £150m to the Liverpool Victoria Friendly Society was agreed. The sale was completed on 16 February 2001.

110. The financial position of the Society at the year-end is summarised in table 5.4 overleaf. During 2000 net assets grew from £32.9 billion to £33.6 billion. This represented total annual net asset growth of 2%. Premium income (net of reassurances) fell from £3.5 billion in 1999 to £2.9 billion in 2000 representing an annual decline of 16%. Premium income included £1.8 billion relating to new business and of which, £1.5 billion was written as single premium business[14]. Investment income received for the year was £2.7 billion. The investment yield achieved for the year was 3.7%. The investment return achieved by the Society on its

[13] See paragraph 88 above.
[14] See financial tables, tables B.4 and C.4.

with-profits business was 2.7%. This was reflected by a disclosed unrealised loss on investments of £1.7 billion. Reserves of £2.5 billion were transferred from the fund for future appropriations to profit and loss account. This was done to augment actuarially determined surplus[15].

111. The Society ended the year with investments, stated at market value, of £33.8 billion and a net asset value of £33.6 billion. Technical provisions of £31.2 billion and a fund for future appropriations of £2.3 billion represented these net assets. The effect of the above was that as at 31 December 2000 the Society had £2.3 billion in un-appropriated reserves, which represented a solvency ratio of 7%[16].

Table 5.4: abridged 2000 balance sheet

	1999 £m	2000 £m
Total investments	32,855.8	33,779.1
Current assets	638.6	695.6
Total assets	33,494.4	34,474.7
Subordinated liabilities	346.2	346.2
Current liabilities	240.4	576.0
Net assets	**32,907.8**	**33,552.5**
Technical provisions	28,066.7	31,241.2
Fund for future appropriations	4,841.1	2,311.3
Total fund value	**32,907.8**	**33,552.5**
Fund for future appropriations:		
- Opening balance	3,025.3	4,841.1
- Transfer (to) from the P&L account	1,822.9	(2,530.0)
- Exchange gain (loss) on retranslation	(7.1)	0.2
- Closing balance	**4,841.1**	**2,311.3**

112. January 2001 was a busy month. The Board met on 10 January. Professional executive search consultants were appointed to find a new chairman to replace Sclater. The sale process continued and was reported on. It was stated that a number of the offers envisaged an agreement between the Society and the GAR policyholders, as part of the ultimate proposals. Headdon reported on discussions that had taken place recently with various groups representing members and the growing acceptance that such an agreement would be in the interests of all the Society's policyholders. He said that work was under way to develop a possible scheme. Dawson expressed concern about undertaking any unconditional transaction without member approval. But Headdon responded by emphasising the need for speed. He reported on the current position and on public relations. Preparations for a Treasury Select Committee inquiry were in hand. Policyholders were contacting the Society for information.

113. On 17 January the Board met again. Charles Thomson's appointment was discussed and approved with some reluctance because it had been negotiated without prior discussion with the Board. The severance arrangements for Nash and Headdon's remuneration package were discussed. Thomson was welcomed to the meeting. He was appointed as the appointed actuary with effect from that day. There was an updated report on the sale process. The terms of reference of the Treasury Select Committee inquiry were intimated.

[15] See financial tables, table B.4.

[16] See financial tables, table C.4.

114. A lengthy report on bonus, prepared by actuarial department staff, was presented in Thomson's name on 24 January 2001. It presented the first draft results for the valuation as at 31 December 2000 and continued earlier discussions as to the appropriate level of bonuses to be determined at the forthcoming bonus declaration. There was extensive discussion of the issues and topics affecting the valuation results. The report discussed the general approach to the valuation; pension transfer and opt-out cases; guaranteed annuity rates and declared bonuses in one section; the draft results for the 31 December 2000 valuation, addressing both the Companies Act presentation and the regulatory returns (particularly the form 9 presentation); in a second section and final bonuses in a third section.

115. The report repeated much earlier material. In relation to the general approach to valuation, it narrated, as fact, that:

> " 4. Directors will recall that, in the financial conditions prevailing since 1997, reserves were established at a level which essentially represented the 'full value' of guaranteed benefits with, in the regulatory returns, an additional 'resilience reserve'. That represented a markedly higher level of reserves than had been necessary in the financial conditions of earlier years."

There was no critical assessment of the necessity for higher reserves in years prior to 1997 when liabilities under the annuity guarantee provisions of the contracts had begun to emerge.

116. The report discussed the implications of revised insurance companies regulations coming into force at the end of May 2000. GAD had issued amended guidance with regard to resilience reserves. Professional guidance for appointed actuaries regarding the new regulations had been issued in draft form but was still undergoing consultation and might still raise issues when its final form was established. The new regulations would affect the rate of interest that would be assumed for the reinvestment of future cash. This would have a disproportionate effect on GAR reserves. The reserving methodology for with-profits recurrent single premium business was defined more tightly. There were new resilience tests that were more onerous. It was appreciated that overall mathematical reserving would be more demanding and would be likely to affect adversely the Society's regulatory solvency position.

117. The report stated that the explicit reserve included since the 31 December 1998 valuation to cover any additional liabilities arising from guaranteed annuity rates was established in the Companies Act accounts on a prudent commercial view of the cost of any additional benefits payable to policyholders with contracts incorporating GARs. It stated that in establishing that provision it had assumed that the Court of Appeal judgment would be upheld: the impact of the failure of that assumption was not described. It was reported that in the statutory returns reserves had to be established in accordance with regulatory guidance, but that the amount was mitigated by the reassurance arrangement. The House of Lords' judgment had had an impact on both the statutory reserves and the level of the Companies Act technical provisions for GARs.

118. There was reference to the changed parameters for valuation interest rates, intended to reflect the relevant regulatory limits in current financial conditions. There would be corresponding changes to other assumptions in order to maintain the basic result for with profits business of a valuation reserve equal to the full current value of guaranteed policy benefits. For non-profit business (principally annuities in payment) the decrease in discount rates would lead to an increase in reserves reflecting the capital appreciation in the matching fixed interest assets over the year. There was reference to mortality. Over the years annuitants had exhibited progressively improving mortality experience. In the light of those trends, it was said that the annuitant mortality assumptions used in the valuation had been progressively strengthened over the years including at the 1999 valuation. Thomson said that it was appropriate to make a further strengthening for male mortality in 2000 the effect of which is included in the figures presented in later sections.

119. The report continued with an analysis of the pensions transfers and opt-outs and the free-standing additional voluntary contributions (FSAVC) review, and the financial implications for the Society. The estimated costs had risen from £200m at 31 December 1999, of which £70m had been paid, to £280m at 31 December 2000, of which £150m had been paid. There had been an increase in the numbers of relevant cases. In addition the removal of seven months' growth in response to the *Hyman* decision had increased the level of compensation payment that were required (now referred to as 'redress costs'). He analysed the movements in the estimates in detail. An explicit reserve had been set up for the FSAVC review of £6m, with an additional provision for administration costs. A total provision of £130m had been set up. The progressive increase in recognition of the Society's exposure to mis-selling claims as a result of past selling practices continued.

120. The report discussed the provision for annuity guarantee liabilities. The *Hyman* decision required review of the provisions. The conclusion of the discussion of the provision in the Companies Act accounts was:

> "20. The best estimate of the likely cost of the House of Lords' decision was quoted in our press release on 8 December 2000 as £1.5bn. This included £0.2bn for the cost of the rectification scheme. The future GAR costs are estimated to be £1.3bn based on a GAR take-up rate of 50% and a long-term view of interest rates. The experience to date supports the 50% assumption especially when it is considered that long-term rates have been suppressed in recent months.
>
> 21. The technical provisions should be calculated on a realistically prudent basis but unlike the commercial cost need only cover GARs on guaranteed funds (that is, excluding non-guaranteed final bonus). The interest rate assumed should be somewhat less than that assumed for the best estimate commercial cost and the take-up rate should also reflect that.
>
> 22. Almost all policyholders retiring wish to take their tax-free cash lump sum to the maximum level allowed. One could therefore think that the upper level for a take-up rate might be 75%. A prudently realistic level would therefore sit somewhere between this level and that assumed for the best estimate of 50%. The fact that the reinsurance treaty has been renegotiated at a level of 60% take-up with very little increase in premium indicates that a 60% take-up level would appear to be justifiable as realistically prudent.
>
> 23. At a take-up of 60% and an interest rate of 4.25% (which is consistent with previous years), the technical provisions would be set at £1.8bn - a figure consistent with the net GAR reserve indicated in paragraph 25. The final basis for the figures still needs to be agreed as there may be more flexibility for the technical provisions in the Report and Accounts than for the statutory reserves in the Insurance Directorate returns. In the figures below we have included a GAR provision of £1.8bn but the final figures may be somewhat different. It should be noted that the technical provision is not a net of reassurance figure."

At this stage it is only necessary to observe that the renegotiation of the reinsurance treaty had left its principal characteristics unchanged, and that was reflected in the premium level.

121. The report next discussed the regulatory position. The financial consequences of the review of the year-end position were summarised as shown at the top of the page opposite. On both bases, therefore, provision of £1.8 billion was said to be required for the annuity guarantee liabilities. The value attributed to improved annuitant mortality was not distinguished from that related to changed financial conditions. The £0.4 billion was later to come to be described as attributable to mortality alone.

	£bn
"Gross GAR reserve at 31.12.99	1. 7
Increase due to take-up rate	0.1
Increase due to changed regulatory requirements	0.3
Increase due to changed financial conditions/annuitant mortality	0.4
Increase due to future premiums	0.2
Gross GAR reserve at 31.12.00	2.7
Less reassurance	0.9
Net GAR reserve at 31.12.00	1.8

A net GAR reserve of £1.8bn is included in the draft statutory figures given below. The final figure appearing in the HMT Returns for 2000 could be different as the figures become finalised."

122. In respect of declared bonus, the paper stated:

"26. The paper on the Bonus Declaration to the November Board indicated that deferring the bonus declaration was a sensible approach. The key concern is that adding to liabilities when statutory solvency is already thin increases the risk of statutory insolvency in the event of equity market falls. With the further falls in markets and the collapse of the first sale process, it is now even more important that no bonus is declared for the 2000 year. The figures in paragraphs 28 and 31 are based on that assumption. Work has already commenced on preparing how policyholders and press will be informed. Directors are invited to endorse the view that no declared bonus should be added for the 2000 year."

123. The current draft key figures for the 2000 statutory accounts were set out:

	"2000 (draft) £m	1999 £m
Value of total net assets	33,620	32,902
Technical provisions	31,250	28,061
Fund for Future Appropriations	2,370	4,841

Although the Fund for Future Appropriations is significantly below its 1999 level it is only £0.6bn below the 1998 level of £3bn."

The overall return on the fund at market value 2000 was 2.9% (14.7% in 1999) and the return attributable to with profits business in respect of 2000 was 2.7% (16.0% in 1999).

124. The estimated regulatory position was:

	"2000 (draft) £m	1999 £m
Statutory value of assets	33,700	32,870
Future profits implicit item	1,000	925
	34,700	33,795
Mathematical reserves		
- basic	(29,400)	(27,869)
- GAR reserve	(1,850)	(565)
- resilience reserve	(1,900)	(1,500)
	(33,150)	(29,934)
Available assets	1,550	3,861
Minimum statutory solvency margin	(1,200)	(1,114)
'Free' assets	350	2,747
Available assets/minimum margin	1.3	3.5"

It was said that the lower cover ratio for 31 December 2000 reflected the low return in 2000, the increased GAR reserves due to the House of Lords' decision and the regulatory and experience changes mentioned above. A 5% fall in equity values could alter the cover ratio by 0.5x.

125. On final bonus, the policy value roll-up rate forward had been set at 9%, as already mentioned. The report stated that the allocation over the past five years of a rate marginally below earnings had, effectively, been smoothing the effects of 1994[17]. Allocating more than was earned in 2000 would increase the differential between policy values and assets at market value. Allocated returns would need to be below earnings again in the future. It was represented that:

> "35. This is, of course, the normal smoothing process we have seen for many years but the thin solvency position and the on going sale process means that it is desirable that any additional shortfall in 2000 should be kept as small as possible. There has also been some comments made in the media encouraging pension policyholders to 'take retirement benefits' to avoid the financial adjustment. Although there is no evidence to date that this is occurring on any large scale the fund is open to selection of this type and a significant imbalance between assets and policy values could put further strain on the solvency of the fund. The position is being monitored.
>
> 36. Having earned just under 3 % for the year, an allocated rate lower than the interim rate of 9% would be consistent with PRE. The comments made in the press release concerning lower future returns might also lead policyholders to expect some reduction but too high a reduction might undermine that message with policyholders and press and cause a renewed surge of policy terminations.
>
> 37. In 1999 we earned 16.0% with about 40% of that return caused by the pre-millennium surge which evaporated on 4 January 2000. A rate was allocated for the year of 12%. An earned rate of 2.7% might indicate an allocated return for 2000 in the range 6 8%. The combined actual return over 1999 and 2000 (therefore eliminating the effect of the millennium 'froth') is 19%. From this we should deduct 1% for the annual management charge over the two years. With 12% allocated in 1999, this would appear to give further credence to a rate around 7% for 2000."

126. The report then analysed competitive data for endowment business. Given the uncertainties in markets and of the sales process, Thomson recommended that the Board should set the ongoing rate in 2001 at a cautious level, below that for 2000. He proposed 6% for endowment business, and 8% for UK pension business for 2000 with equivalent treatment of other classes, with an ongoing rate with effect from 1 January 2001 of 6% p.a. with effect from 1 March 2001.

127. At the board meeting on 24 January various committees reported, and there was an extensive report on the sales process. Headdon had submitted a report as chief executive covering a range of issues. He reported on the steps taken in implementation of the rectification scheme. Thomson reported on the valuation and declaration. Thomson noted that the solvency position was more heavily dependent on section 68 orders than would be normal. Even if all of the orders sought were granted the solvency position would be weak. The guaranteed annuity rate provision was heavily dependent on interest rate assumptions. Final bonus was a commercial decision. The Board supported his recommendations.

The Halifax deal

128. The dominant issue for the Board through January 2001 was clearly the exploration of options for providing stability for the with-profits fund and securing

[17] Compare Headdon's explanation on 26 July 2000, quoted at paragraph 86 above.

the best interests of policyholders. It is not for me to evaluate the deal that was struck with Halifax plc, or indeed the associated compromise proposals that were published after the launch of this inquiry (and outside my remit). But it is appropriate to describe the central features of the sale and some of the background.

129. In the course of the post-closure sale process, a number of bidders conducted due diligence. The possibility of a collective industry solution of the kind that had avoided exposure of problems in other companies was also explored, though the moral hazard of bailing out a firm that was perceived to have been "run with too little capital for a long time" appears to have proved too much of a disincentive. The factors that FSA intended to take into account in considering any proposal for disposal of the business were set out in an internal memo on 16 January:

> "• The fairness of the proposal to policyholders in general, and to each of the main classes of policyholder (GAR and non-GAR);
>
> • Financial factors, notably the impact of the proposal on the strength of the Equitable fund or any replacement to it and the wider group of which Equitable may become a part;
>
> • The commitment of the bidder to the deal, and to the longer term interests of the Equitable policyholders in the way the deal is followed through;
>
> • How convincing the proposal is, in terms both of how well the proposal fits the strategic objectives of the bidder, and how attractive it is likely to be to policyholders;
>
> • The strength of the management, and its ability to carry through the proposal;
>
> • The regulatory standing of the bidder, both in the UK and (in the case of overseas bidders) in its own jurisdiction;
>
> • Whether the bid is likely to produce a better outcome overall compared with a continuation of the closed fund."

Earlier optimism was now clearly tempered by a realistic assessment of the problems associated with the Society's financial position. Those criteria were disclosed to Headdon in a letter three days later, in which it was also made clear to the Society that, subject to any regulatory issues being resolved, or taken into account, the decision as to what proposals to put to the members was one for the directors. This was also to be communicated to the potential bidders through the Society's advisers on the sale.

130. On 24 January one bidder pulled out citing weakness of the fund, and in particular the difficulty it would have in meeting new valuation requirements in respect of terminal bonus, the difficulties of achieving a solution to the "GAR/non-GAR problem", the time that would be required, and the doubtful value of the sales force if, despite the Society's hopes, a quick return to selling with-profits policies was not in prospect.

131. Following negotiations, Halifax offered to purchase from Equitable the Society's operating and asset management assets, unit linked and certain non-profit in-force business and certain subsidiaries, subject to contract, by written offer dated 28 January 2001. The terms of the offer were posted on the Society's web-site. An acceptance was endorsed on that letter on 28 January. The primary acquisition was intended to be by Clerical Medical Investment Group (Holdings) Ltd. That company's board met on 1 February. It was envisaged that agreements would be signed on 1 or 2 February and announced on 5 February. The structure of the proposal, which the board of Halifax plc resolved to approve on 2 February, had not then been finalised, but the components of the price were to be an initial payment of £500m; and, subject to a satisfactory, binding, resolution of disputes between the Society and its guaranteed and non-guaranteed annuity policyholders, a further sum of £250m, unconditionally, and a further sum of £250m contingent on the achievement of

defined sales and profitability targets in 2003 and 2004 by the transferring ("Halifax Equitable") sales force. In addition, following acquisition of the business, the company and/or certain of its subsidiaries would provide administration and asset management services to the closed fund on agreed terms.

132. The 28 January letter set out the heads of agreement as between Halifax and Equitable. It incorporated a disclosure list by the Society of certain facts, some of which have wider significance. It was disclosed that the rectification scheme' to settle claims of annuity guarantee policyholders that had previously matured was now known, had been circulated, that there had been no sign of any challenge, that work had commenced on individual calculations, and that the rectification scheme might require revision once the compromise scheme between GAR and non-GAR interests (which would require the approval of the Court in terms of section 425 of the Companies Act) was effected.

133. The letter also disclosed risks of litigation relating to the annuity guarantee issue. In respect of litigation there was disclosure of the risks of claims from policyholders making contributions after the *Hyman* decision in the House of Lords; after the Court of Appeal; after the Treasury letter to managing directors of life offices dated 18 December 1998[18]; after 1993 when the annuity guarantees became a cost; and after 1956 due to non-disclosure that non-GAR policyholders could have to subsidise the annuity guarantees. There was also a risk of litigation based on the failure of the Board to take legal advice on differential bonuses. There might be actions against directors. There could be adverse reaction to Nash's termination arrangements. The composition of the new Board could be contentious. There could be a challenge of the sale taking place without a members' vote. Typically of such contractual disclosure letters, many of the items reflected the imagination of legal advisers' rather than risks that management would have recognised as realistic. But some of the disclosures reflected risks of claims that remained live at the inquiry's reference date.

134. The Board met on 1 February to discuss the Halifax offer. Dawson reported that it was recommended that Vanni Treves be appointed president of the Society. There was discussion of Headdon's remuneration.

135. The offer document was revised on 3 February. One element of the agreement took the form of an irrevocable offer for the business (as defined) open to acceptance on 5 February, by payment by Lovells, now the Society's solicitors, to the purchasers' solicitors of £100 in cash. Completion date was 1 March. The definition of the assets sold as part of the business included goodwill. The document dealt with the proposed scheme of arrangement. The Society was obliged as soon as practicable to prepare and put before each class of its creditors a scheme for approval, along lines outlined in the document. The scheme was to be subject to the prior written approval of the Halifax. The scheme overall was subject to confirmation from FSA that they had no objection to it. The cost of the scheme was to be borne by the Society, extending to a comprehensive indemnity of Halifax and its officers and employees. There were very onerous ancillary obligations imposed on Equitable.

136. The outline of the requirements was brief:

> "OBJECTIVES OF THE PROPOSED SCHEME
>
> (a) The compromise of the guaranteed annuity rights enjoyed by certain policyholders;
>
> (b) All creditors of the Closed Fund entitled to vote on the Proposed Scheme being bound by the Proposed Scheme;
>
> (c) The compensation to be provided under the Proposed Scheme in respect of compromised guaranteed annuity rights being fair and reasonable as between the various classes of creditors entitled to vote thereon

[18] See appendix D and chapter 17.

(including its effect on the solvency of the Closed Fund and taking into account the amounts paid or payable by the Purchaser pursuant to this Agreement);

(d) The classes of creditors of the Closed Fund, whose approval of the Proposed Scheme is required in accordance with Section 425(2) of the 1985 Act being no greater than the minimum practicable in the circumstances;

(e) The operative provisions of the Proposed Scheme being as simple as reasonably possible (in order to assist effective communication to policyholders and other interested parties); and

(f) The Offeree being in a position to implement the Proposed Scheme in accordance with its terms."

The Society had assumed some demanding obligations.

137. The Society's Board met on 4 February to review developments relating to the sale to Halifax since 1 February. The offer document was produced. It was explained that the offer was conditional upon the unanimous resolution of the Society's Board. Once accepted, completion of the contract would then be dependent only on minor regulatory clearances. Agreement to a scheme of arrangement under section 425 of the Companies Act 1985 was noted to be a key element of the proposals. The scheme would increase the policy values of annuity guarantee policyholders in exchange for giving up their GAR rights. Consequently the offer provided for the entry into a secured term loan facility for a maximum principal amount of £251m outstanding at any time. The facility agreement would provide for:

- Aggregate loans of £250m to be made before the scheme of arrangement had become effective, on terms that the Society's obligation to repay such loans (other than an amount of £1m) would be released upon the effective date of the scheme of arrangement; and
- A further loan of £250m to be made upon the scheme of arrangement becoming effective, on terms that the Society's obligation to repay all outstanding amounts would be released to the extent that the sales performance and profitability of the new business written by the Halifax group under the Equitable brand met or exceeded certain targets.

It was resolved to accept the offer on 4 February. The negotiation of minor variations was delegated to Headdon and Thomas.

138. An intervention by another potential buyer was discussed on 7 February. On 14 February Treves was appointed director with a view to appointment as president, and the valuation was discussed. Thomson's revised report was available. He rehearsed the principal recommendation in the January report. He then turned to new factors. The Halifax sale was mentioned. The compromise scheme was mentioned. He recommended that bonus declaration be deferred until the outcome of the compromise proposals was known. He said that the Halifax deal did not undermine the economics underlying his earlier recommendations of 8% for 2000 and 6% for 2001. But he recommended that the Board defer the second reduction. He expressed views on the timing of change. He provided up to date financial information.

139. At the meeting Thomson told directors that he had thought it right to review his recommendations in the light of the Halifax contract and the developments in the compromise scheme. He confirmed the recommendation that the declaration be deferred until after the disposal of the compromise proposals. On-going rates should change at March 2001 instead of January. But the rate recommendation remained the same. The Board accepted his recommendations.

140. The Halifax agreement was modified by a letter dated 1 March with an appendix of revisions accepted and held as incorporated in the terms of the original

offer, correspondence confirming the exclusion of 'the treasures' of Equitable from the scope of the transaction, and a range of subordinate agreements for the provision of administrative, assets management and other services and other ancillary matters.

141. In due course, Halifax waived repayment of the first tranche of £250m following the approval of the scheme of arrangement. The Society and Halifax agreed to amend the facility agreement to provide that the second £250m would not be lent, but that Halifax would pay a sum equivalent to any amount that would have been waived under the original agreement. No credit was taken for any part of that sum in the Society's published financial statements at 31 December 2002, and that can be taken to reflect the position at 31 August 2001. The final tranche of the price was unlikely to be realised in view of the state of the life market at the reference date.

142. On 26 February FSA told the Society that there was no IMRO[19] objection to the transaction and PIA also intimated their approval.

143. The mechanics of the transaction were subject to considerable revision. In the end the £500m initial consideration was allocated as to £170m for the sale of the business; £30m for the Society's properties used for its business; and £300m allocated to re-insurance commission on the in-force business transferred. The draft reinsurance treaty was sent to the regulator. It would appear that it must be assumed that the allocation of the consideration paid was realistically allocated among the specified heads in the proportions indicated.

144. The documents were reviewed by GAD, although it was thought that none of the arrangements required formal approval under any of the regulatory regimes. GAD wished to ensure that the contracts enabled Equitable to maintain satisfactory arrangements, for example for the protection of its policyholders, and to ensure that it continued to be able to comply with PIA conduct of business rules. The regulatory focus was on whether the contracts transferred to Halifax any responsibilities that GAD considered should not be contracted out by an authorised insurance company. It was also thought important to ensure that adequate arrangements would be maintained by the Society to monitor performance against the contracts. In the event, the regulators were involved in detailed discussion of a number of aspects of the scheme. But the focus tended to be on future regulation, and the ability of the Society to meet its obligations as a regulated company. The fundamentals were not considered in detail.

145. As mentioned in paragraph 137 above, there was a late bid at the beginning of February, after the Society had entered exclusive negotiations with Halifax. FSA contacted the Society and Halifax to ensure that it was not dismissed without due consideration. In the event the new bid was not considered to be satisfactory, and the reasons given to the inquiry for this by regulatory witnesses and the incoming chief executive have been consistent and credible. It would not in any case be sensible for me to seek to reassess any of the options considered. I am satisfied that the necessary professional advice was obtained and that the regulators were diligent in their consideration of the regulatory implications of the transactions carried into effect at this stage.

146. The deal with Halifax was struck as described. I do not see any value in recounting the details further. But I should note the suggestion, made to the inquiry by the new chief executive, Charles Thomson, that the sale to Halifax was carried out with unusual expedition at the time of his appointment. Thomson told the inquiry that at the time he favoured further consideration of the possibility of continuing to run the Society's whole business as a closed fund. I cannot now assess whether such an option would have yielded better results for policyholders. As I have attempted to show, the problems with the Society were deep-seated, and it is easy to understand the desire of the outgoing management to conclude a deal and

[19] The Investment Management Regulatory Organisation Ltd, a self-regulating organisation under the 1986 Act.

provide some measure of stability for policyholders going forward. I have seen no evidence to suggest that any other considerations were at operation.

Bonus decisions in 2001

147. Discussions during 2000 had set the scene for the approach to bonus during 2000 and 2001. On 2 August 2000, the Society circulated policyholders intimating that new final bonus rates had been introduced on 20 July 2000. It intimated that "normal" growth would resume from 1 August 2000. Non-GAR policyholders would receive a lower growth rate, but it was intended that the loss of seven months' growth would be made good from the proceeds of sale of the business. GAR policyholders would receive no growth for the period to 31 July 2000. Further information was promised. The composition of the new Board was intimated to policyholders in a circular letter dated 25 April 2001. The letter commented on the implications of the withholding of seven months' growth in 2000, and the decision to withhold declaration for 2000. The letter stated:

> "The Equitable did not allocate any investment growth to bonuses which increase guarantees in 2000 because to do so would have further constrained our investment freedom. Instead, after allowing for any guaranteed growth under the policy terms, all bonuses were allocated in the form of non-guaranteed final bonus. This does not alter the total benefits being paid under policies currently, only the balance of the guaranteed and non-guaranteed elements."

148. The new Board encouraged the view that the Society could at that stage continue to operate on the basis of continuing allocated growth. The only material change was in the division between guaranteed and non-guaranteed benefits, and that was said to be related to investment freedom. In a leaflet distributed on 8 May 2001 to with-profits annuitants, it was forecast that the returns allocated to with-profits annuities might be expected to be 1½% to 2% per annum lower for the next five years. However, the letter repeated the view that it would not be appropriate to add bonuses for the year ended 31 December 2000 in declared, guaranteed form. The decision would be reviewed on implementation of the compromise scheme. The new Board were preparing relevant policyholders for a downturn in their expectations. But there remained an optimistic note:

> "The deferment of the addition of declared bonus will not affect the level of your annuity payments if the current interim rates of return continue to apply. It is purely the composition of the annuity between guaranteed and non-guaranteed elements that is affected by the deferments of the bonus declaration."

It would have been reasonable for policyholders to have inferred that there was no information available to the Board that would affect the prospects of meeting the expectations that the letter generated.

149. On 16 July 2001 the Society announced the results of a review of its financial position. The statement included the paragraph:

> "The outcome of this review and the need to ensure fairness between all policyholders have led the Board to reduce final bonuses on with profits policies. Pension policies will be reduced by an amount equal to 16% (14% for life assurance policies) of the policy value as at 31 December 2000. In addition, there will be no growth on policies for the period from 1 January 2001 to 30 June 2001. From 1 July 2001 the growth rate accruing to a policy during the current year will now be currently 6% (5% for life assurance policies) per annum. Guarantees under policy contracts will, of course, be met."

It was said that the decision had been taken and could not be delayed because equity markets had fallen, maturity values exceeded the value of the investments

underlying maturing policies, and a large number of people were taking their benefits. These reasons underlined the essential weakness of the Society, so far as published. Typically, the circular narrated that maturity values exceeded underlying asset values without discussing how that situation had come about.. The number of people in a position to take benefits was, in part, a function of the very flexible maturity terms written into the contracts. High maturity values were a function of the allocation of high returns to policyholders in pursuance of the Board's bonus allocation and payout policies. The vulnerability to market value fluctuations was obvious from experience quite apart from general market characteristics. The one consoling factor to emerge from the statement was that the market value adjustment was reduced from 15% to 7½% because policy values were now nearer to the value of underlying investments.

150. Although there had been a change of Board, there was little immediate improvement in the communication skills of the Society. The directors intimated that they had decided to reduce final bonuses, by applying uniform deductions to total policy values according to policy class. If the accrued final bonus was large enough, the reduction might be accommodated. But for newer business that could not have been expected, and as discussed later was not expected. The fixed rate reduction appeared to affect guaranteed benefits. To meet that contingency, it was promised that guarantees would be honoured in due course. In an example this it was stated: "If the guaranteed value of the policy is above (the reduced amount) on maturity in accordance with policy terms, the higher figure will be paid." The impact on with profits annuitants was to be spread over five years. The statement contained a further paragraph:

> "Policy values increased at the rate of 8% per annum in 2000, although 4.7% was set aside to pay for the additional cost of GAR policies, giving net growth of 3.3%. In 2001, prior to the bonus reductions announced today, growth has been accruing to policies at the rate of 8% per annum."

Reconciliation of all of the statements and rates might have been expected to cause a degree of confusion in policyholders' minds. For example, it would not have been clear whether subsequent non-guaranteed allocations would have been applied in the first place, in the case of newer business, to make good the difference between guaranteed benefits and the reduced amount, as the example suggested.

151. Policyholders were issued with 'ready reckoner' sheets to enable them to re-compute the values of their policies at 30 June 2001 according to class. They were advised to take the total value of with-profits benefits at 31 December 2000 from the annual statement issued in March 2001 and multiply that value by a factor. In the case of pension policies the factor was 0.84, to achieve a reduction of 16%. For life assurance policies the factor was 0.86. To that sum they were instructed to add any premiums paid between 1 January 2001 and 30 June 2001 and deduct payments received. They were informed that if the guaranteed value of the policy was higher than the revised policy value brought out then, on maturity or other contractual event the higher figure would be paid. Superficially, the scheme used in the reckoner provided an insight into the July statement. The guarantees at 31 December were not removed finally: in an ill-defined way it was put in suspense pending maturity. But there were unanswered questions. It was not made clear how and on what basis any new bonuses would be declared. It was not made clear how the continuing contractual guarantees, in particular the guaranteed investment rates of return and the annuity guarantees, would apply. It was not stated whether any future declared bonuses would simply reduce the deficit, so that until the 31 December guaranteed level was restored there would be no net benefit at all.

152. In the context of the compromise scheme, the Society issued statements of policy values on 1 October. As an example, one policyholder's retirement annuity policy had a total policy value of £126,600 attributed to it. The value, if guaranteed terms applied, would have been £143,100. On transfer other than at maturity, the total value would be reduced by the financial adjustment (then at 10%) to £114,000.

At 31 December 2000, the total value had been £148,500 on the basis of valuation then applicable. The December value would have been reduced to £124,700 by the application of the 0.84 factor. The 3½% rate of investment return should have applied between then and 1 October to the guaranteed benefits. But the October statement did not disclose the adjustments, nor the arithmetical links between the various factors. Policyholders could have been in some doubt about the factors affecting their entitlement to bonus previously accrued and continuing. Without access to the current Board's thinking on these matters, I can only express sympathy for those who have found difficulty in understanding their positions.

PART III: THE SOCIETY'S FINANCIAL POSITION

CHAPTER 6: LIFTING THE VEIL

1. The Society survived the *Hyman* decision, and adjusted its financial position in response to it. As indicated in the last chapter, the Society's best estimate of the likely cost of the annuity guarantees, including the rectification scheme, was £1.5 billion at the end of 2000. Withholding seven months' value of the return otherwise allocated to policyholders supplemented the Society's capital resources and compensated for the increased liability thrown up by the annuity guarantees. The Society continued to trade. But from the date of the decision of the House of Lords, it was thought necessary to proceed to a sale. Failure to find a buyer for the whole business resulted in the Society closing to new business on 8 December 2000. In the event sales of parts of the business produced £650m by March 2001. Another £250m was credited to the Society after the inquiry's reference date on the completion of the compromise scheme. But there was no interest in the with-profits business and it was not sold. The new Board cut policy values by 14% or 16% depending on policy class in July 2001. It is necessary to consider what made the with-profits business so weak and unattractive to the market, and to discuss the factors that made a cut in policy values necessary if the Society were to continue in business. The Companies Act financial statements summarised in the last chapter would not have disclosed the reasons.

2. The Society used three different approaches to asset and liability valuation in its Companies Act accounts, regulatory returns, and internally for management purposes, its 'office' valuation. The accounts reflected the requirements of the Companies Act. The regulatory returns reflected the requirements of the Insurance Companies Acts and related regulations. The office basis was developed in-house over many years with some outside consultancy input. At 31 December 2000 the respective presentations, for the whole business, were, in summary:

Table 6.1: Financial position at 31 December 2000 on the three bases[1]

	Internal Office Valuation £m	Companies Act Accounts £m	Regulatory Return £m
Net assets	33,569	33,553	33,526
Technical provisions/			
Mathematical reserves	(30,693)	(31,242)	(32,894)
Accrued terminal bonus	(5,933)	-	-
Liabilities	(36,626)	(31,242)	(32,894)
(Deficit) Surplus	**(3,057)**	**2,311**	**632**

Subject to the discussion that follows, the office valuation approximated to a realistic presentation of the Society's actual financial position.

3. The differences in the overall results reflected a range of accounting treatments and the technical assumptions used. Assets in the Companies Act accounts required to be stated on a true and fair view basis, including deferred acquisition costs, for example. For regulatory purposes admissible assets only, as defined in the regulations, were reckonable. Deferred acquisition costs were not taken into account as an identifiable item. In the office valuation deferred acquisition costs were excluded and the new business loan generated by the Society's internal accounting system substituted.

[1] See financial tables, tables G.1, G.3 and G.5.

4. The guaranteed annuity provisions at 31 December 1999 and 2000 reflected differences in approach of particular importance:

Table 6.2: Guaranteed annuity provisions at 31 December 1999 and 2000[2]

	Internal Office Valuation £m	Companies Act Accounts £m	Regulatory Return £m
1999			
Gross	50	200	1,663
Reinsurance	-	-	(1,098)
Net	**50**	**200**	**565**
2000			
Gross	1,500	1,668	2,631
Reinsurance	-	-	(808)
Net	**1,500**	**1,668**	**1,823**

The internal office valuation represented the Society's assessment of the realistic cost of the annuity guarantees before and after the decision in *Hyman*. The Companies Act accounts reflected the assessment of the true and fair provision required for the liability to GAR policyholders and former policyholders, again before and after the decision. The regulatory presentation took account of a financial reinsurance arrangement entered into by the Society.

5. Of the various presentations of the annuity guarantee cost, the most onerous, on that basis, was the regulatory return valuation, net of reassurance, of £1.8 billion at 31 December 2000, representing approximately 5% of the regulatory return liabilities reflected in its mathematical reserves[3]. A cost of that amount was proportionately of a level that the Society had absorbed in the past. In 1990 and 1994 it had survived negative returns on considerably smaller with-profits funds of 10.4% and 4.2% respectively, allocating growth rates of 12% and 10% at a cost of about £560m and £1.2 billion. However, market volatility presented problems different in kind from the annuity guarantee liability. Historically markets had recovered after significant falls, and there was always a prospect of recovery, to some degree and at some stage.

6. By contrast to the market falls of the early 1990s, the annuity guarantee liability could not be expected to be reversed, and compensation would have to be found if it was available from the Society's resources. That is what occurred. Further, it was what would have been expected. The Society had been presented throughout as well-funded, dynamic and forward-looking, with a successful record and a robust financial position. It was committed to mutuality. It had, in terms of its published financial position, a record of impressive growth notwithstanding the investment shocks of 1990 and 1994. Superficially, an additional liability of £1.8 billion should not have brought down a fund with regulatory net assets valued at over £33 billion or undermined its viability to the extent that the business as a whole could not be sold. The cut in policy values in July suggested a need to consider why, notwithstanding the financial position brought out in the Companies Act accounts discussed in the last chapter, the Society could not continue in its normal way following the *Hyman* decision.

7. A comprehensive reconciliation of the various differences is unnecessary for present purposes. But it is necessary to distinguish the various approaches to understand, in the first place, what the realistic position of the Society was; thereafter how the presentation in the published financial statements differed; and

[2] See financial tables, tables G.1, G.3 and G.5.

[3] The comparison is relatively crude, and does not take account of adjustments in the resilience computations that would reduce the difference.

finally to make some comments on the limitations in the published statements that contributed to a misunderstanding of the Society's position, and to a considerable extent to the adverse reactions that followed ultimate publication of its position in the summer of 2001.

8. At 31 August 2001, as the inquiry terms of reference make clear, the sequence of events leading to the position at that date required investigation - not least because the impression built up over time by the Society's presentation of its financial position appeared to have been undermined. Given its history of response to challenging financial environments, it might reasonably have been expected to be able to absorb the capital cost of the adverse decision in the *Hyman* case without exposing itself to sale. In terms of value, the cost arising from the decision was at a level that had to have been within the reasonable contemplation of experienced fund managers at all material times as the value of a shock that could arise from present and future market volatility. The commitment to mutuality, so frequently and eloquently expressed by the Society's directors, would have inclined the observer to expect that sale would be a course of last resort, reflecting acceptance that the Society could not survive independently. An independent observer, equipped with the information published by the Society in its financial statements and marketing literature, would have believed that if the Society had changed its policy stance on mutuality and put the business on the market, there would have been a successful sale realising a substantial surplus for allocation to policyholders.

9. At the date the inquiry was instructed there was a common belief that the decision of the House of Lords had 'caused' the collapse of the Society. From representations received first from policyholders, and later from HMT and FSA in the course of the maxwellisation procedure, it seems that that belief persists in certain quarters. HMT and FSA in particular continue to maintain that there was no over-allocation of bonus, or 'over-bonusing' in their terms. But it appeared early in the inquiry process that the resilience of the Society had to have been affected adversely by other factors for a liability of the sum involved to have had such a massive impact. Failure in the sale process, followed by partial disposals of relatively low value compared to expectations, leaving behind the vulnerable with-profits business complete with its liabilities, necessarily gave rise to questions about the Society's actual financial position. Closure to new business raised similar questions. The cut in policy values on 16 July 2001, by 14% or 16%, depending on policy class, on the eve of publication of the compromise scheme, was a further indication of weakness brought forward at that date.

The Office Valuation

10. An analysis of aggregate policy values as generated by the office valuation from the introduction of the new bonus system in 1989 to 2000 is set out in the table 6.3 overleaf. The table presents values for the major components of the fund. Variations among different cohorts of with-profits policyholders are discussed later. Liabilities were included at full value, that is, as presented to policyholders in benefits statements. The accounting systems that generated individual benefits statements generated the aggregate values that were used internally. The liabilities therefore included the contractual guarantees in respect of contributions, the guaranteed investment interest to date and declared reversionary bonuses. In addition the accrued terminal bonus values were included. In and after 1998 the annuity guarantee provision was included. Recurrent single premium contract guarantee values were at full face value.

11. While the basic figures reflected in the table have been obtained directly from the Society and presented in a manner consistent with the internal use of such data, the FSA have made representations to the inquiry on similar projected data extracted from another source and which presents a somewhat different picture to that brought out in the table. The FSA have expressed concern that there is a risk of misunderstanding of the extent and significance of the deficits as reflected in

column E of the table. They have contended that while with-profits assets are valued on a market basis, they take no account of the embedded value inherent within a with-profits fund and hence do not reflect the true or realistic value of the fund's assets. They have intimated that under the FSA's new realistic reporting rules embedded value would be taken into account when performing a realistic valuation. The sale to Halifax of the unit-linked business for £300m was given by the FSA as an example of such embedded value. In the last chapter I have indicated the final description of that sum as reinsurance commission.

Table 6.3: Policy values over available assets (office valuation)[4]

Year	Net assets	Non-profit & Unit-linked liabilities	With-profits available assets	Aggregate policy values[5]	Unfunded policy value position	WP policy values as a % of available assets
	£m	£m	£m	£m	£m	%
	[A]	[B]	[C=A-B]	[D]	[E=C-D]	[F=E/C]
1989	5,855	(934)	4,921	5,166	(245)	105%
1990	5,935	(1,033)	4,902	6,277	(1,375)	128%
1991	7,547	(1,281)	6,266	7,805	(1,539)	125%
1992	9,699	(1,784)	7,915	9,214	(1,299)	116%
1993	13,548	(2,668)	10,880	11,065	(185)	102%
1994	13,708	(2,891)	10,817	12,956	(2,139)	120%
1995	16,804	(3,438)	13,366	14,962	(1,596)	112%
1996	19,520	(3,822)	15,699	17,424	(1,725)	111%
1997	23,918	(4,678)	19,240	20,598	(1,358)	107%
1998	28,343	(6,976)	21,367	23,567	(2,200)	110%
1999	33,188	(7,049)	26,139	26,873	(734)	103%
2000	33,569	(7,725)	25,843	28,900	(3,057)	112%

12. While the FSA may choose to include such additional values in future regulatory valuations, which have in the past sought to apply a more stringent or prudent test of solvency (demonstrated by the exclusion of inadmissible assets among other factors), including embedded value in going concern accounts for general purposes has in the past been at least controversial, and in any event the valuation of such items will no doubt prove to be highly complex and subjective. In the case of the sale to Halifax the very nature of the payment was redefined in the course of negotiations. Regardless of the FSA'S current views, the Society managed its business on a going concern basis, using the information contained in the table as a measure of its realistic position. The "deficits" or unfunded positions were real to the Society and decisions made reflected attempts to restore balance in the fund in response to the deficits brought out. I have not been persuaded by FSA's representations that it is inappropriate to adopt this material for the purposes of this report in an assessment of the developing realistic position of the Society.

13. In the case of a with-profits policy of the later forms issued by the Society, the policy was divided into segments. For each with-profits segment a 'sum assured' and 'related bonuses' were calculated. The expressions were defined as follows:

> "(a) The Sum Assured secured by a With-Profits Segment shall be a variable sum equal at any particular date to 95.5% or such higher percentage as the Actuary shall at his absolute discretion determine of the total of the premiums which have been attributed to such Segment.

[4] See financial tables, table G.5.

[5] With-profit liabilities including terminal bonus.

(b) Related Bonuses are also variable and will be calculated by the Actuary at any particular date in accordance with the rules and regulations of the Society."

14. Benefits statements for different classes of business varied in presentation of the relevant data. But in all cases they brought into account 95.5% of the relevant contributions, accumulated that sum at the guaranteed investment rate of return (GIR), which might be zero, and aggregated with those sums the declared bonuses brought forward and added at the date of the statement. To that sum the notices added terminal bonus by methods that varied over time. In relatively late forms the movements of terminal bonus were shown separately from the movements in contractual benefits. The office valuation reflected all of these elements. Both internally and in communications with policyholders, from about 1986, the Society emphasised that with-profits policyholders participated in a 'managed fund' that, subject to some smoothing, gave them the benefit of the returns earned on their investment, net of the expenses specified, during the currency of the policy. The policy values intimated to members individually, and the aggregates reflected in the office valuation, were representations of the actual bonus allocation and distribution policies of the Board.

15. In relation to assets there were differences among the three approaches in recorded investment values. Investments were generally valued at market value. Factors that distinguished the office valuation from the other financial statements were (a) the treatment of acquisition costs, and (b) the treatment of development expenditure. These factors tended to be of less material value in cash terms than differences in the valuation assumptions inherent in the three methods. The contractual presentation of expenses, as 4½% of contributions, did not reflect accurately the acquisition cost of new business. The actual cost was considerably higher. The Society developed the mechanism of an internal 'new business loan' to capitalise the excess un-recouped acquisition costs with a view to recovering them over the anticipated life of the contract. In the case of recurrent single premium business, there was no contractual obligation on policyholders to make further contributions, but experience pointed to a pattern of recurrent payments. Over the period covered by table 6.3 the outstanding new business loan increased from £150m at 31 December 1989 to £500m at 31 December 2000, having peaked in 1999. Deferred development expenditure was credited in the office valuation to reflect the view that this expenditure, for instance on computer technology, would be recovered from future cost savings over time and should not be written off as it was incurred. The sums involved were never large, and fell from £54m in 1993, when the item was first introduced, to £16m in 2000.

16. Each of these adjustments strengthened the overall presentation of the financial position. But on an internal going-concern basis the adjustments were not open to objection, provided that the Society's experience of renewal of recurrent single premium business justified the assumptions that additional contributions would be received despite the lack of any obligation on the policyholder to make them. No evidence has suggested that these adjustments were inappropriate.

17. The records of aggregate policy values distinguished with-profits policy values from non-profit and unit-linked liabilities, and the related assets. The analysis in table 6.3 reflects information prepared in 2001 for the then appointed actuary, Peter Nowell, but continued exercises that had been carried out over time by his predecessors. The method had been used by Ranson in providing information to regulators in the early 1990s[6], and by Headdon until at least 1997. Aggregate policy values were explicitly rolled forward from year to year, reflecting practice in and after 1989. The primary interest for present purposes is in the with-profits values. The methodology applied in the Society's internal calculations identified the assets available to cover with-profits liabilities by deducting non-profit and unit-linked values from total net assets at market value, and expressing total with-profits policy

[6] See chapter 16, paragraph 77.

values as a percentage of the available asset values so deduced. The methodology made no pretence at absolute accuracy, but it appeared to be a practical approach that, applied by the Society consistently from year to year, provided a starting point of acceptable reliability. It ignored any value embedded in the non-profit and unit-linked business, reflecting the consistent view of the Society that it should not seek profit from business which it saw as providing a service to its with-profits policyholders, and, perhaps more realistically, the fact that no part of any embedded value was realisable while the Society continued to pursue its established policies and mutuality in particular.[7]

18. The opening position in 1989 showed aggregate with-profits policy values amounting to 105% of the assets attributable to the with-profits fund. It is clear that 1989 was not the first year of the final period in which an excess of with-profits liabilities over available assets arose, and that 1989 was not in any sense 'in balance'. In 1989 the Society had a good rate of return in the markets. Of a total return of approximately 26%, a total growth rate of 20% was allocated[8], comprising guaranteed investment returns, and reversionary and terminal bonuses. The Society under-allocated available returns in the year by about 6%, which the Society retained. In 1988 15% out of a total return of 15.1% was allocated. It can reasonably be inferred, therefore, that the excess of policy values over available assets at the beginning of the period was attributable to a balance brought forward from 1987 and possibly earlier years. The allocation over earlier periods cannot be analysed accurately on information available to the inquiry. But it is clear that the opening position did reflect earlier over-allocation, consistent with the analysis of the bonus papers presented to the Board. The position from 1989 to 2000 is shown graphically in figure 6.6 below.

19. From the 1989 position of an excess of 5% of policy values over available assets, 1990 showed a dramatic increase in excess to 28%. 1991 showed little recovery. The position was pulled back in 1992 and 1993. In 1994, the second year in the series reflecting significant reductions in investment values, the excess rose again to 20%. With the exception of 1998, when the excess rose to 10%, the trend was generally downwards until 1999. In 2000 the excess rose again, to 12%, notwithstanding the impact of the decision not to allocate a bonus for the first 7 months of the year. The Society withheld from allocation £1,455m which financed the increase in the office valuation for the annuity guarantee liabilities to £1.5 billion[9]. Developments over the first eight months of 2001 are dealt with later.

20. The basic characteristics of the office valuation, and the distinction between it and the published position, can be illustrated in the 1990 figures. The long-term liabilities in the office valuation were valued at £5,888m. In addition the valuation showed accrued terminal bonus of £1,422m. In the regulatory returns the mathematical reserves were valued at £5,362m, and accrued terminal bonus was not recognised. In the Companies Act accounts the technical provisions were stated at £5,576m. Again there was no recognition of accrued terminal bonus. In 1989 the comparative values for the long-term liabilities had been: office valuation £4,698m; mathematical reserves £4,703m; and technical provisions £4,704m. The 1989 position reflected a relationship one might typically expect, though the near identity between the regulatory and Companies Act bases might have been thought to be somewhat contrived. The marked change in 1990 reflected the consistent application of practice as between the two years in relation to the office valuation on the one hand but a marked departure in the case of the regulatory and Companies Act

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[7] The with-profits values have been extracted and are set out in the financial tables, table G.5.

[8] In this chapter 'allocation' is used to describe the process of applying the total rate of return to policyholders to policy values brought forward, to distinguish the process from the declaration of reversionary bonuses on the one hand and the payment of policy proceeds on the other.

[9] It has been suggested that because of the yield on the fund, the seven months' retention was simply notional money re-allocated from a smoothing account. So far as policyholders were concerned, it appears that the money was more real than the smoothing account. The society's hypothetical smoothing account was in deficit.

financial statements on the other. I shall discuss the change in the published statements more fully later. At this stage it is sufficient to note in the case of the office valuation that it continued to reflect the full value of the liabilities as intimated to policyholders, and in addition reflected the full accrued value of the non-guaranteed final bonuses intimated to policyholders.[10]

21. At no accounting date reflected in the table was the total position in balance. The figures showed over-allocation to with-profits policyholders at each year-end from 1989 until 2000. The pattern reflected the Board's decisions in 1990, 1994 and 2000 to make allocations significantly higher than the available assets would then support, followed in the first two instances by periods in which there were attempts to claw back the position from better financial results. The attempts never quite succeeded, even in the most favourable years. The picture that emerges at least until 1996 has been presented as the Society's approach to 'smoothing', which was characterised by Chris Headdon in August 1997 as "smoothing... 'across the peaks'". As I understand that expression, it reflects accurately an approach that depended on periodical stock market surges to support major, if temporary, claw-backs of over-allocation as opportunity allowed while, at least until the second half of the 1990s, consistently allocating bonus beyond available means.

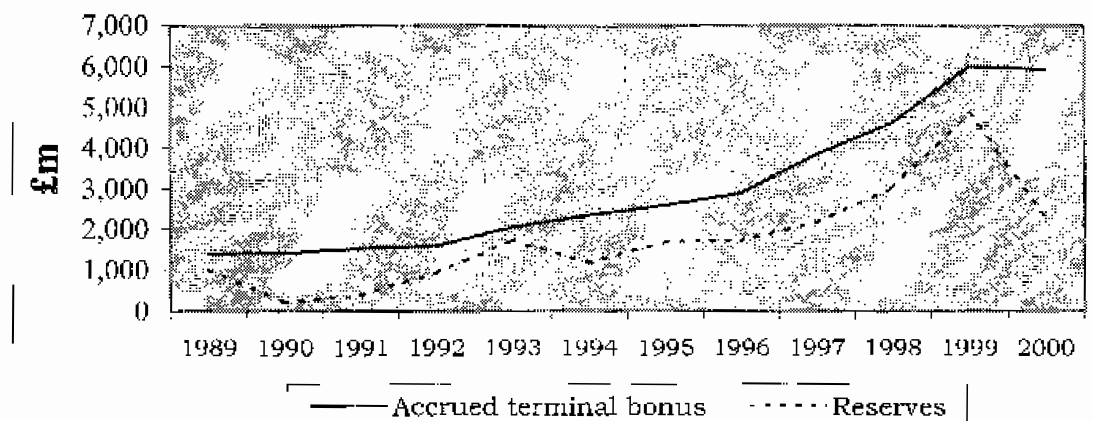
22. As I understand it, 'smoothing' is a technique employed by actuaries in the management of with-profits business that seeks, in theory, to adjust actual returns on with-profits investments to a predetermined financial projection so as to provide for the structured release of surplus for allocation as bonus. A smoothing policy, according to this theory, would specify a projected target return, incorporating an assumed rate of growth; maximum deviations above and below the projection; and the duration of the cycle to achieve equilibrium between the projected and actual returns. In reality, such a policy would be unlikely to be realised over time, and adjustments would be required to reflect experience. But it would be difficult to envisage any rational smoothing policy that did not allow for the holding of surplus assets from time to time, during that phase of the cycle when actual returns exceeded projected returns, to balance periods when over-allocation was necessary as against actual returns to support bonus allocation. Acceptance of the retention of surplus earnings by the office is part of the price with-profits policyholders accept for the stability of bonus through good times and bad. In the chapters on bonus, I have sought to demonstrate how the Society's free assets were eroded over the 1980s by the policies adopted until there was a net excess of policy values over available assets. The table shows that there was no reversal of this position throughout the 1990s.

23. Figure 6.4 on the next page demonstrates graphically the relationship between the Society's reserves available to pay future terminal bonus and the office value of accrued terminal bonus. At no point through the 1990s did the Society have sufficient reserves to cover terminal bonus exposure at full cash value. The gap, as would be expected, widened at 1990, 1994 and 2000.

24. Equivalent office valuation data is not available prior to 1989. But, as discussed earlier, the Society's published strength altered materially over many years. The sizeable free estate of 1972 had been dissipated as a result of the valuation and bonus allocation practices adopted between 1973 and 1976. Substantial recovery had been achieved by 1982. Modification of reserving policies in the period 1982 to 1984 had removed the 'second call' reserve for future reversionary bonuses. The terminal bonus pool was increased and applied in significantly increased un-guaranteed allocations of surplus until by 1987 at the latest aggregate allocations exceeded available assets at market value.

[10] See financial tables, tables G.1 to G.5.

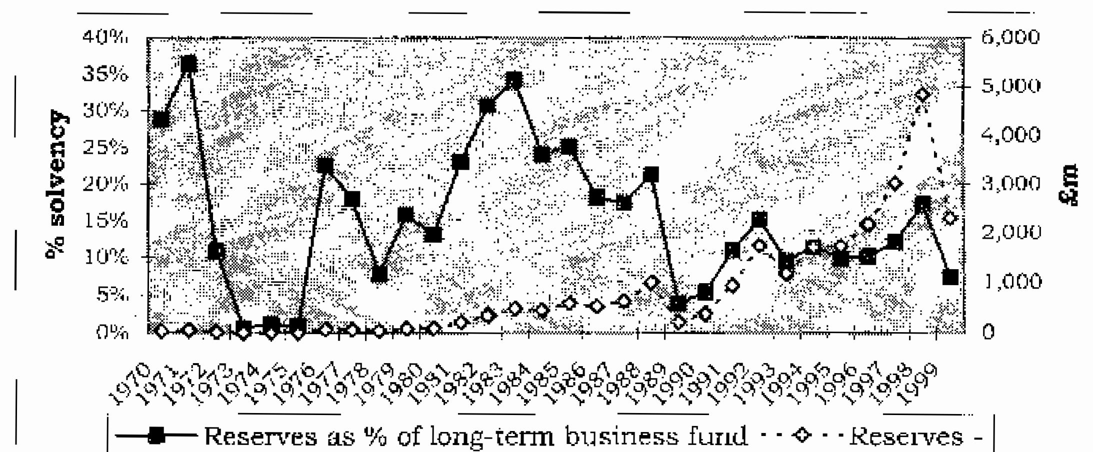
Figure 6.4: Smoothing position: 1989 to 2000



Note: reserves include the investment reserve (1989 to 1993) and the fund for future appropriations (1994 to 2000), as disclosed in the Companies Act accounts. Accrued terminal bonus is reflected in the Society's internal office valuation.

25. An over-view of the position from 1970 to 2000, as set out in the Companies Act accounts, is shown in figure 6.5 below. The cash value of the reserves (the right hand scale in the figure) traces the movements in the investment reserve, later the fund for future appropriations, over the period. Hidden margins and other reserves in liabilities, such as general reserves for expenses and for AIDS, are not reflected in the figure. As one might expect from earlier discussion, the major reductions were in 1973 and 1974, 1990, 1994 and 2000. But the ratio of reserves to the long-term business fund perhaps describes more eloquently the impact of policy decisions on profit allocation. The Board's response to the economic position in the 1970s reduced solvency cover to near zero. Between then and 1982 the graph shows the build up of reserves following the Board's decision to restore strength. The rate of growth fell slightly in 1982 when the reduction of the value of the second call began. The move towards full distribution through the remainder of the decade, culminating in the dramatic collapse in solvency cover in 1990 appears clearly from the shape of the graph. Thereafter the Society was never in a position of particular strength, as was shown by the 1994 and 2000 reductions in the face of market shock.

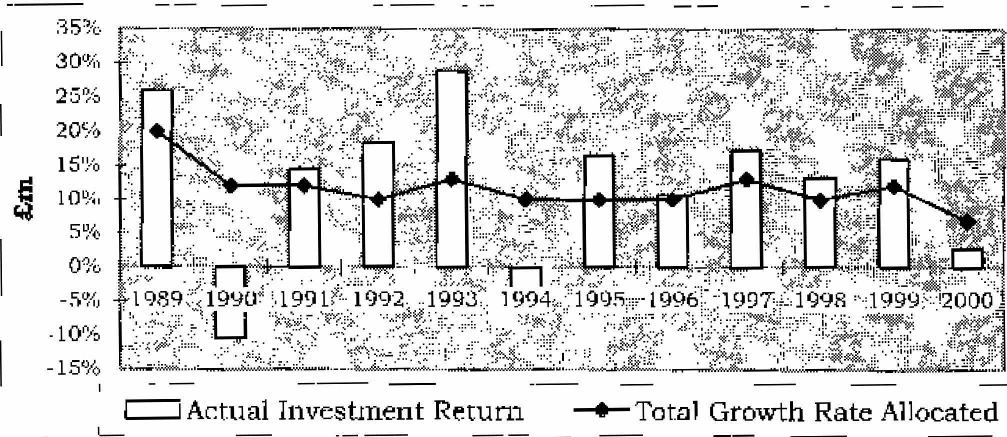
Figure 6.5: Reserves



26. From 1994 until 1999 the reserves, as disclosed in the Companies Act accounts, rose, both in value and as a percentage of the long-term business fund. The picture that emerges from the two figures over the period 1989 to 2000 reflects a range of factors. In the first place the allocation growth rate was sustained at high

levels, with, in Headdon's terms, 'smoothing across the peaks'. This is shown in figure 6.6 on the page opposite.

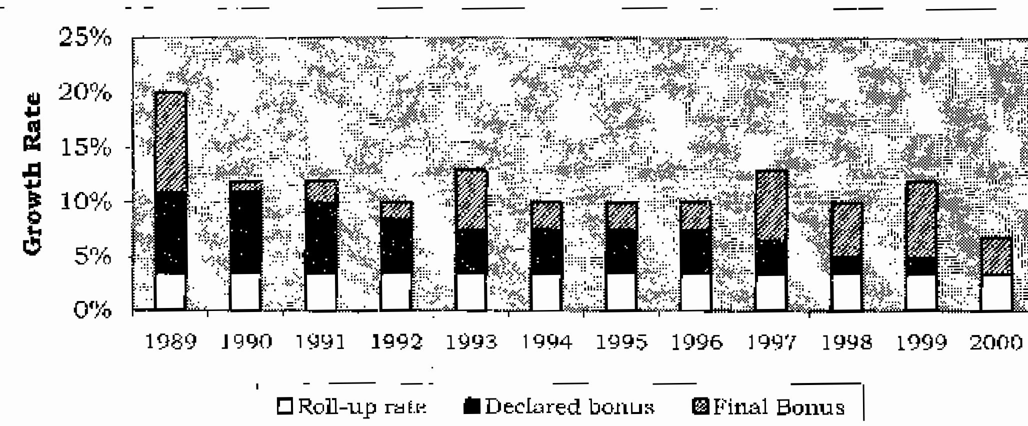
Figure 6.6: Growth rate allocations: 1989 to 2000



Comparing allotments with investment returns, the Society allotted the majority of its actual returns when there were good results and, with the exception of 1993, made poor attempts at recovery after over-allocation in bad years. This was a major contributory factor to the excess of aggregate with-profits policy values over available assets.

27. However, the crude overall position cloaks more complex factors. As noted above reserves as a percentage of the long-term fund increased between 1994 and 1999. Two factors contributed significantly to the developing picture. In the first place there was a marked shift in bonus mix between declared reversionary and terminal bonus. In the second place there was a material change in product specification that involved reduction in guarantees reflected in the liabilities. In the 1980s and 1990s the Society increased substantially the proportion of terminal, later final, bonus in its total bonus allocations. It accounted for this element of bonus on a cash basis on claims. The introduction of the new bonus system in 1989 provided insight into the results as they developed through the 1990s:

Figure 6.7: Analysis of growth rate allocation



Under the system in force from 1989, the terminal bonus allocations were cumulative. The reducing contribution of declared bonus to the overall growth in policy values is clear. The result of this was that additions to liabilities decelerated in value and percentage terms, and the additions to terminal bonus accruals accelerated. The data relates to pensions business in the form written before 1996. The 3½% contractual GIR was fixed. Reversionary bonuses fell progressively. Terminal bonus was volatile, but accumulated over time. Since only the guaranteed return and reversionary bonuses elements of the return were reserved for as

liabilities, the accounts progressively lost touch with the real nature of the Society's business, in which terminal bonus was increasingly material as an element in total returns to policyholders, and, significantly for marketing purposes, in policy proceeds.

28. After 1 July 1996, when the Society withdrew the guaranteed investment return from new business, the aggregate allocations did not change immediately. New business was allocated a reversionary bonus equal to the sum of the guaranteed investment return and reversionary bonus on older classes of business. But that was not guaranteed and the potential for differentiation was created. The differentiation became real in the case of contracts with a zero growth rate: the proportionate contribution of terminal bonus to total allocations was significantly greater than shown in figure 6.7 on the last page. The Society increasingly used contract forms that carried no right to investment guarantees or reversionary bonus, starting with some forms of its investment bond[11]. In 1998 new recurrent single premium contracts were introduced generally with no right to reversionary bonus. Again the result was a shift in the relative mix of reversionary and terminal bonus in the total growth allocation. Over this period inflation caused investment returns generally to fall: reductions in guarantees would have been prudent. But the removal of the guarantees reflected wider policy objectives.

29. During the early 1990s over-allocation was an industry wide issue. The Society was not alone in its practices. However the context in which the Society competed with others needs to be considered. Unlike other insurers, the Society did not have significant free reserves or an estate from which to draw support in its application of smoothing. The Society also had a more mature with-profits business, which meant over-allocation was crystallising at a higher cash cost than that experienced by other insurers. Therefore while the Society sought to compete head to head on allocations with others in the industry, the risks it exposed the with-profits fund to were considerable greater than those faced by its competitors.

Technical Efficiency in Policy Design

30. The amendment of the Society's policy forms to reduce the incidence of guarantees offered to policyholders reduced the requirements for liability valuation generally, transferring value increasingly to the terminal bonus element of total returns. The office valuation was least affected of the three, since terminal bonus was included in the aggregate. But presentation was affected. As in other contexts, pension contracts are taken to be representative of the with-profits fund as a whole in view of their relative volume, and the discussion is focused on them accordingly.

31. As already discussed in chapter 2, pension policies sold until 1988 contained tables that guaranteed the level of pension at retirement. Annuity guarantees in this form did not survive the move in July 1988 from retirement annuities to personal pensions for new business purposes and was removed from group pension schemes for new members by 1993. Pensions policies written before and after 1 July 1988 incorporated implicitly or explicitly a guaranteed interest rate by which the total policy value to date, excluding terminal bonus when that was introduced, increased each year up to the date when the policyholder started to draw the benefits as a pension. Equitable's retirement policies from 1957 contained an implicit 2½% GIR. In 1971 the rate was increased to 3% per annum. In 1975 it was increased to 3½% per annum. The GIR was added to the total policy value before any declared or reversionary bonus was added. It was one of the elements used in producing the table of 'Guaranteed Rates of Annuity' for retirement annuity contracts. When commutation tables were introduced in 1972, the guaranteed interest rate became apparent on analysis, but was not explicitly advertised. GIRs emerged as an explicit item at the time of the launch of personal pension plans and were a replacement for

[11] See chapter 4 paragraph 41. Some investment bonds carried onerous capital back guarantees that became very expensive options at the end of the 1990s and later.

specifying the amount of annuity at vesting date under retirement annuity contracts.

32. In the late 1980s and early 1990s, the Society became aware that its policy forms were limiting investment freedom because of the need to reserve for guaranteed liabilities, and resolved to alter product design to provide products that were more 'technically efficient'. The first such product was the with-profits annuity, which was very popular and attracted a sizeable proportion of the business that would probably otherwise have been sold as conventional level annuities. Increasing longevity made fixed annuities in possession increasingly expensive. Ranson's with-profits annuity treated each year of payment as a recurrent single premium (RSP) policy, or a pure endowment. It was thought to be helpful to have this business in with-profits rather than non-profit form since over time it reduced contractual liabilities. The question whether the increased risk arising from dependence on terminal bonus was made sufficiently clear to policyholders at the point of sale of the products that were developed with this feature is not one for me to resolve. It is clear from representations I have received that there is scope for dispute. While the policyholders' risk profile increased through the Society's strategic shift in balance between un-guaranteed versus guaranteed benefits, the Society directly benefited from a company perspective by reducing its exposure to guaranteed liabilities.

33. Future developments were anticipated in a paper entitled 'With Profits Policies with No Guarantees' in 1990 that set out proposals for contracts with no guaranteed rate of interest and provided for all bonuses to be in terminal form. The result would have been that a higher proportion of policy value would have been in un-guaranteed form. Policy forms implementing these proposals were not introduced for some years. In the meantime, in early 1991, the Society's management began discussions on reducing the reserving requirements in respect of older forms of contract[12]. It was proposed that on withdrawals from the with-profits fund the amount withdrawn should be treated as a 'negative premium' reducing the guaranteed fund in the first instance and leaving aggregate un-guaranteed benefits unaffected. The effect intended was that a higher proportion of the residual policy value would be unconsolidated. A worked example showed the effect on a hypothetical policy with a value of £10,700 comprising a guaranteed fund of £5,000, declared bonus of £3,000 and terminal bonus of £2,700. Under current methods a withdrawal of £8,000 would be spread proportionately over these items. Under the proposed method the £8,000 would be applied as a 'negative premium', wiping out the guaranteed fund and declared bonuses and leaving the residue as terminal bonus for which no reserving would be required.

34. This proposal was initially treated as agreed policy on 15 May 1991. It appears that existing IT systems could not cope with implementation and that it was not pursued. However, the proposal illustrates the extent to which management was prepared to introduce changes in assumptions or in approach that were designed to reduce liabilities at the time. Since the value of declared bonuses depended in part on accrued guaranteed benefits brought forward, it is not clear how the accrual of future bonuses on the residual accrued terminal bonus fund would have been managed or communicated to the policyholder. That was not discussed in any document recovered. The attempt to equate taking a benefit available under the contract (to withdraw funds subject to policy conditions) with a repayment of premium was imaginative, but of doubtful competency since the policyholder might reasonably expect to get a proportionate terminal bonus depending on investment conditions at the time of withdrawal. However, that is less significant in a discussion of the Society's financial position than is the fact that management were prepared to consider such an expedient at the time.

35. The proposal to introduce contracts with a zero guaranteed rate of interest was revived in 1996 when it was decided to launch, for pensions and with-profits

[12] Meeting of the product investigation team (PIT)[12] on 16 January 1991, there was a paper on the with-profits bond.

annuities, an RSP contract with an effective guaranteed rate of interest of 0%. At that time, it was envisaged that all other aspects of the structure of the contract would be the same as for existing RSP contracts. All RSP life assurance contracts (apart from with-profit annuities) already had a 0% guaranteed rate of interest by that time. The proposal was said to be associated with the pursuit of greater investment freedom. But it was recognised that it would also have 'a positive effect' on the Society's solvency position. The proposal was accepted at the PIT meeting on 18 March 1996. Guaranteed interest rates of 0% were introduced from 1 July 1996 for new contracts.

36. There is no evidence that the Board was consulted at the time. Headdon (soon to become appointed actuary) and Ranson (soon to retire, but then managing director and actuary) made reference to the decision in their joint paper to the Board on 12 December 1996. The paper did not refer to the reserving implications of the change of form, but stated that it brought the Society's contracts into line with market practice, made them easier for clients to understand and would give more flexibility in the management of the business if the Society experienced a sustained period of low investment returns.

37. The Society's forms of contract were not uniformly 'technically efficient' in their original forms. Some required high levels of initial capital to be held. In the case of internal scheme changes, or transfers, such as from retirement annuity contracts or personal pensions to managed pensions or with-profits annuities, this involved crystallisation of accrued terminal bonus. Equitable introduced two forms of income draw-down policy:

a. The managed annuity, sold from 1 October 1993 until 16 March 1994, which was withdrawn at the insistence of the Inland Revenue; and

b. The managed pension, sold in three versions from 3 July 1995 with decreasing guarantees. Initially there was a 3½% yearly GIR and entitlement to annual declared bonus; then from 1 July 1996 there was no GIR, but an entitlement to annual declared bonus; and finally, between 12 March 1998 and 8 December 2000 (a period of very high sales volumes), there was a version which contained neither a GIR, nor an entitlement to annual declared bonus.

The timing of the changes in the second form reflects the progression towards policy forms that, over time, would come to have reduced reserving requirements. Reserving for managed pension and with-profits annuity contracts became less demanding with policy duration. The application of withdrawals against guaranteed funds, associated with new allocations on a mix increasingly skewed towards terminal bonus, reduced the guaranteed element of the contract over time, but initially there was a significant capital cost. In September 1997 the onerous reserving requirements of the existing form of managed pension were recognised. The form generated substantial capital needs, depressing the Society's published solvency margin. The business also carried a significant commercial financial risk for the Society if there was wide-scale switching from with-profits managed pensions to conventional annuities at a time of depressed market values.

38. The PIT response on how to "reduce the solvency requirements" was that a new policy series under which all bonuses would be in the form of terminal bonuses could be launched. A specification was instructed. In addition, the PIT proposed that benefits should be left unconsolidated when existing Equitable polices were converted to managed pensions. That was to be included in the specification.

39. There were continuing concerns about the bonus structure of the managed pension at the end of 1997. A paper by Andrew Soundy was presented to the PIT in December 1997 in which he summarised proposals for the future. Reversionary bonuses would be eliminated for new business. The guaranteed fund would never increase and would be reduced on withdrawals. New forms and literature would be produced. He raised again the issue whether terminal bonus should be consolidated

on purchase of a managed pension using the proceeds of an existing Equitable personal pension plan or treated as an internal transfer" that preserved the characteristics of the transferred fund. And so the plan developed to remove all entitlement to reversionary bonuses from managed pensions sold on or after 12 March 1998. A draft field force bulletin informed sales staff of the decisions on 12 March 1998. The problems experienced with the with-profits bond finally led to its withdrawal in September 1998, when it was superseded by the personal investment plan, which had less generous guaranteed withdrawal terms.

40. A further trend that emerged in the late 1990s was related to changing the product mix to adjust solvency requirements. In an internal memo to PIT members dated 9 March 1998, Headdon expressed the view that one could not make all products equally capital efficient. The "trick" was to manage the overall business mix so that the total position was satisfactory. He proposed selling additional business that would not otherwise be secured in linked form as, typically, that would consume less capital than the with-profits alternative. He supported the design and sale of products that eliminated features which significantly increased capital demands but brought little or no market advantage. Headdon had no objection to products with relatively unattractive capital requirements if there were a clear market need for them, and gave the managed pension as an example.

41. In a paper dated 29 April 1998, presented by Headdon to the 7 May 1998 PIT meeting, the theme continued. He explained the capital requirements of unit-linked products, comparing them with with-profits business. While emphasising the need to maintain with-profits business as the source of working capital, Headdon sought to encourage linked product sales to reduce reserving requirements. Technical reserves for linked liabilities grew from £2.4 billion in 1997 to £3.1, £4.2, and £4.5 billion in 1998, 1999 and 2000 respectively[13].

42. It is not possible to quantify the results of implementing these policies relating to product design individually or cumulatively. Together they represented a developing trend of changing policy design and adapting marketing policy to reduce the impact on the Society of reserving requirements. To the extent that these policy changes were successfully implemented, they compounded the effect of reducing declared reversionary bonuses in decreasing the proportion of the Society's total business activity that was exposed to technical reserving requirements for office, regulatory and statutory accounts purposes. The changes were introduced over a period in which there were high levels of premium income. Such changes to overcome reserving requirements across the three forms of financial reporting was a growing industry trend and acknowledged by various parties through the 1990s. Equitable's overall approach was not unique. But the reserving implications were of particular importance to the Society because of its weak capital base.

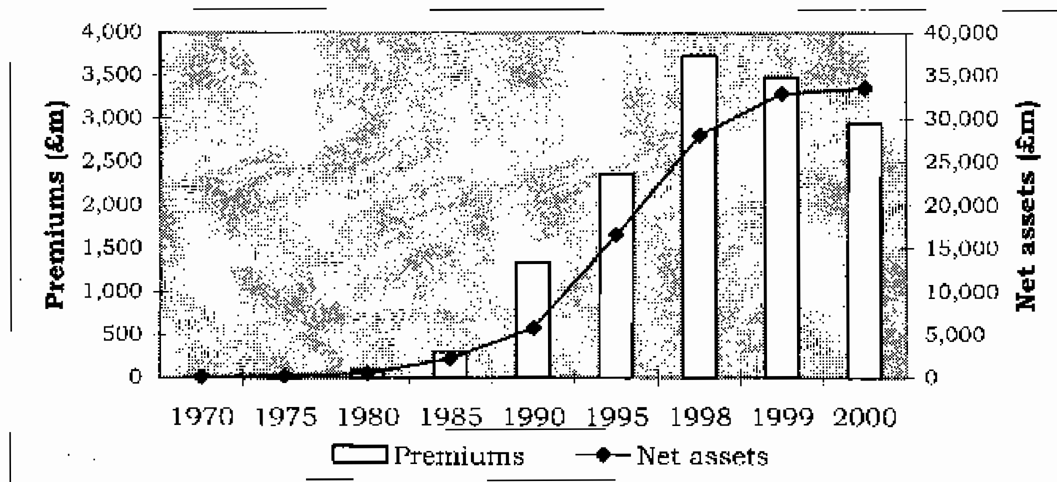
The Pattern of Allocation

43. While precise analysis of the contributions of these factors to the overall position cannot be provided, some indication of the importance of the change in product specification can be inferred from the pattern of business growth as shown in figure 6.8 on the next page. As the figure demonstrates, in value terms the Society experienced progressively increasing growth in net assets throughout the period until 2000. Premium income presented marginally greater growth until 1998. From then on there was an accelerating reduction in premiums received. In 1998 you would expect public awareness of the annuity guarantee issue to be reflected in falling sales of the Society's products. The figure shows a significant concentration of business growth over the period most affected by the shift in bonus mix and the change in product specification. Given the short durations necessarily associated

[13] In comparison with the rest of the industry the more to unit-linked products was about two decades late. However, that reflected the Society's policy of concentrating on with-profits products and regarding other products as a service to members.

with new business over the final few years these may have made a small contribution to total growth relative to business of longer duration, despite their cash value. However, the position over the period was clearly that contractual benefits had fallen and that terminal bonus increased as proportions of the total mix.

Figure 6.8: Growth: 1970 to 2000[14]



44. The inevitable result of the trends that had been established was that accrued terminal bonus would continue to increase as a percentage of total policy values and contractual benefits would fall. New business would accrue increasing amounts of terminal bonus. Older business would mature and, to the extent that the funds were withdrawn from with-profits, the liabilities for accrued contractual benefits in the with-profits fund would be reduced as a result quite apart from the impact on in-force business of progressively reducing rates of declared reversionary bonus.

45. On the realistic accounting basis reflected in the office valuation, by the end of 2000 the Society was under-funded to the extent of £3 billion. The Society had not held sums in its liability provisions or in its fund for future appropriations sufficient to cover the accruing total policy values. Notwithstanding frequent references to smoothing as a technique, there was no smoothing policy evident in the management of the with-profits fund over time that would have restored the position, though there was a material degree of adjustment in and after 1995.

46. In his observations during the 'maxwellisation' process, Ranson has commented that while there was not a rigid mechanistic approach to smoothing, he did advise the Board on the topic, and he drew attention to a paper dated 15 November 1995 in that connection. I have dealt with the paper in the context of bonus policy and practice. At this stage two points require to be made. A policy is not established by a selective reference to the results of a short period. What is required is a statement of parameters, of time and deviation from a specified state of equilibrium, against which decisions can be tested. Whether the data supports the existence of any policy framework for smoothing is a matter of fact. The issue is whether the Board of the Society had a policy that provided a measure of practice and informed decisions in changing circumstances. It has been a theme of comment during 'maxwellisation' that those who have been consulted have complained that I have not 'understood' this or that aspect of management, and in particular that I have failed to understand smoothing. I have not been set the task of resolving whatever debate there might be about the limits of smoothing in with-profits management. But none of those who have provided evidence or comment has identified a smoothing policy that can be related consistently to the practice of the Society over the 1980s and 1990s.

[14] See financial tables, tables A to C.

47. The excess of £3 billion at 31 December 2000 is the simple arithmetical difference between aggregate policy values and available assets. Again that cloaks a more serious underlying situation. Whatever flexibility there might be to adjust policy values in the case of in-force with-profits business, payment or other recognition of a claim crystallises the position in the absence of a practice such as proposed by Soundy in December 1997[15]. As matters developed a substantial proportion of the difference related not to in-force with-profits business, but to previous claims that had crystallised accrued terminal bonus, and aggregated it with declared bonuses and other guarantees so that the full policy value calculated at the date of the claim, subject to any market value adjustment, became a contractual liability. Capital was eroded at the point of claim and the deficit could be recovered only from continuing and new business. The position had engaged the management. In 1997, speaking of the period 1989 to 1996, Headdon wrote in a memo to Nash:

> "In a normal smoothing cycle one would expect a series of positive 'excess claim' figures followed by a series of negatives. The accumulated excess would rise to a peak, fall to a (negative) minimum and return to zero (i.e. a sine wave). The figures indicate that we could be something like 15 years to complete the first half of such a cycle..."[16]

He observed that the normal position described had probably never applied in reality. That comment was accurate in the case of Equitable, though it must be highly doubtful whether any life office ever achieved a smoothing pattern that resembled a sine wave. However a fifteen years period to recovery would extend the curve below the line for a very long time. It is clear from the results in and after 1997, that Headdon, then appointed actuary, made better progress than forecast, at least until 1999. There was a marginal narrowing of the gap in cash terms, and a more pronounced narrowing in percentage terms over a short period of about three years. But the more significant part of the paper related to his analysis of the past.

48. It was recognised by the Equitable actuaries that the simple difference between year-end aggregate policy values and available assets presented a less than comprehensive picture of the position. With the memo to Nash in August 1997, Headdon set out an analysis of the build-up of the excess, seeking to distinguish the part that had previously been crystallised on claims from the balance currently reflected in the in-force business valuations at the respective accounting dates from 1989 to 1996.[17] He explained that discussion of the relationship between the total current value of with-profits business (including terminal bonus) and assets had been used in relation to decisions on the levels of market value adjustments. He said:

> "In the last couple of years some surprise has been expressed that the gap has not narrowed more quickly. That seems counter-intuitive given that we know policy values are below asset share on most business of a term below 5 years and the large volumes of business taken on in those years. The explanation is the excess over assets paid on claims in recent years but we have not analysed that in detail."

The application of current years' surpluses to reduce the excess of aggregate with-profits policy values intimated to policyholders (Headdon's 'policy values') over assets available to cover the with-profits fund (Headdon's 'asset share') had clearly been expected by some executives to reduce the excess more quickly than was happening. Headdon had drawn attention to the significant cause: the excess of policy values accrued at the date of payment, as reflected in the claims values, over the related asset value at that point. Some aspects of that factor have been mentioned and are discussed further below: maturities in the ordinary course crystallised accrued

[15] See paragraph 38 above.
[16] See also chapter 12, paragraph 122.
[17] The table is reproduced in the financial tables to this report, see table H.1.

terminal bonus values, and changes in product design and marketing appear to have aggravated the position.

49. Headdon indicated that he had a method of analysing the impact of claims experience in broad terms, starting from the assumption that 31 December 1989 was an 'in balance' end of a smoothing cycle and then analysing subsequent experience separately between claims and continuing in-force business. Headdon did not claim any great precision for the analysis, but suggested that it showed that for continuing business policy values had on average come back in line with asset shares, and were currently probably marginally below; that over the last seven years the accumulated excess of claims paid over asset shares was around £0.9 billion; and that the true current smoothing cycle was necessarily extremely long. The methodology used in preparing the exercise has been analysed, and the exercise extended to 2000.[18]

50. The extension of the computation can no more claim precise arithmetical accuracy than Headdon did for his original exercise. The inquiry's findings are necessarily expressed in value and percentage terms. They are not presented as precise or lacking flaws. However, the broad methodology that was devised for management purposes provides an acceptable basis for completing the exercise within limits of accuracy that take account of the practical realities of the situation. The overall picture disguises differentials among cohorts of policyholders of different duration, a feature common to these calculations.

51. The Society's claims history reflected a range of transactions. On maturity of a pension policy where the policyholder took a fixed annuity under the contract terms, the claim crystallised the policy value, and what had been treated as accrued terminal bonus became part of the present benefit, reflected in value leaving the with-profits fund with a corresponding reduction in assets attributable to in-force with-profits liabilities. Non-profit liabilities and assets increased correspondingly on internal transfers.

52. Headdon's analysis reflected an assumption that the reductions in in-force business and in assets were equal, and self-cancelling. The full policy value was available to the with-profits policyholder, in the Society's practice, as a cash fund. Cash commutation of approximately 25% of the fund was available. To the extent that the policyholder exercised the commutation option a proportion of the total policy value might leave the fund in absolute terms on an internal transfer. That part included a proportion of the accrued terminal bonus. The net movement in total assets was limited to the cash commutation, but the total value left the with-profits fund. Similarly where the policyholder exercised the open-market option and removed the funds from the Society, there was a transfer of 100% of the fund value that included the accrued terminal bonus. The full value left the with-profits fund, whatever the previous characterisation of its component parts.

53. This could have been mitigated by the application of a market value adjustment, and would have been to some extent during periods when that technique was applied to non-contractual claims. But for considerable periods the Society did not apply market value adjustment at all, and in those periods when it did, it was on a discretionary basis both as to the exercise of the power and as to the quantification of the reduction. The result of the transaction was, again, that the funds affected by the exercise of the option ceased to be in-force business, and were no longer included in the year-end valuation of the with-profits liabilities. On a switch of policy type within the with-profits fund, as on taking up an invitation to convert from a retirement annuity contract to a with-profits annuity in anticipation of retirement in and after 1987, the full policy value of the retirement annuity was presented as a claim, and the proceeds, less any cash commutation drawn, was treated as a new business premium.

[18] The results are set out in table H.2 in the financial tables, with notes on the analysis and the estimations required, and are summarised in table 6.10 below.

Calculating the deficit

54. It would be extremely difficult and time-consuming, if not impossible, to re-work the base data and produce a fully comprehensive analysis of the movements in the fund over the most material period, from 1986 to 2001. It has been necessary to draw on the data that could be found in the Society's records so far as traced by the inquiry. The transfer of the Society's records to storage made the search for and identification of relevant records time consuming and sometimes frustrating work. The financial exercise that could be and that has been carried out remains necessarily crude. It is appropriate to begin from the position of the Society at 31 December 2000. At that date, on the realistic office valuation basis, the financial position of the Society can be expressed as shown in table 6.9:

Table 6.9: The office valuation position at 31 December 2000[19]

	£m
Total investments (stated after net current assets & liabilities)	33,058
New business loan	494
Deferred development expenditure	16
Net assets	**33,569**
Non-profit and unit linked liabilities	7,725
With-profits liabilities at full guaranteed value	21,468
Guaranteed annuity provision	1,500
Technical provisions	**30,693**
Accrued terminal bonus	5,933
Aggregate Policy Values	**36,625**
Unfunded Policy Value Position	**(3,057)**
Accumulated excess credits on claims 1989 to 2000	(1,834)
Balance of excess on in-force business values at 31 Dec 2000	(1,223)
Aggregate with-profit policy values as a % of net assets	**112%**

55. The calculation of the accumulated excess credits on claims between 1989 and 2000, as indicated above, is based on the work of Headdon in August 1997. I am satisfied on the advice I have received that, both in respect of the period computed by Headdon and in respect of the extension, the approximations are sufficiently reliable for present purposes. They are estimates and cannot be precise. But what one seeks are order of magnitude figures that illustrate the substantial position of the Society.

56. The analysis of the excess[20] is set out in table 6.10 on the next page, while the position is shown graphically in figure 6.11 on the following page. The table shows the allocation of the excess of aggregate policy values ('APV') over available assets at each successive year-end. The excess attributable to the in-force business (column D) is shown as the difference between the aggregate (column C) and the rolled-up value of the excess paid on claims (column B). The table shows that in 1993 and 1999 the in-force liabilities were valued below the available assets. It also showed the significant changes in position brought about in 1990, 1994 and 2000 by the distribution policies adopted in those years. In the case of 1999 the result reflects the intuitive view of Headdon that the combination of under-allocations and growth in premium income in and after 1995 was reducing the excess. However, the continuing crystallisation of historically high allocations in earlier years over-compensated, with the result that, net, over-allocation remained the norm.

57. I shall comment below on the financial position in 2001, which might indicate that the analysis to 2000 is conservative. Down to 31 December 2000, the table and figure show, among other things, that a policyholder who had invested in 1989 and

[19] See financial tables, table G.5.

[20] Extracted from table H.2 in the financial tables.

remained in the fund with the same accumulated contributions at 2001 would have benefited from over-distribution and suffered under-distribution over the period, but ended with a near balanced position in cash terms in July 2001. However contributions over the period would have benefited or suffered relative to the point in the cycle at which additional investment was made. Contributions from 1994 onwards that remained in the fund in 2001 would have received proportionately lower returns. On the other hand claims crystallised between 1989 and 2000 would have benefited from over-distribution.

Table 6.10: Accumulated excess credits and excess APV over asset shares

With-profits policies	Current year claims excess (A)	Acc. claims excess (B)	Amount of excess APV (C)	Excess over asset shares (D)
	£m	£m (year end)	£m (year-end)	£m (Difference)
1989	-	-	245	
1990	73	69	1,375	1,306
1991	126	214	1,539	1,325
1992	99	362	1,299	937
1993	29	499	185	(314)
1994	51	528	2,139	1,611
1995	115	741	1,596	855
1996	78	902	1,725	823
1997	128	1,196	1,358	162
1998	90	1,451	2,200	749
1999	42	1,728	734	(994)
2000	**59**	**1,834**	**3,057**	**1,223**

Note: These figures have been derived from workings prepared by Headdon to 1996 and have been rolled forward by the inquiry using his applied methodology.

58. The current year claims excess (column A) represents the total of the cash payments during the year in excess of the policies' underlying asset shares. The aggregate of these payments from 1989 to 2000 is £889m, and is substantially all accrued terminal bonus, which crystallised on payout. While the inquiry has not been able to establish the extent to which such payouts may have been reinvested into the Society, it has been able to establish that, to the extent they were re-invested, the proceeds re-entered the fund as guaranteed additions.

59. Headdon's approach went on to treat such excess payments effectively as borrowings from the fund and he consequently rolled the accumulated claims excess (column B) value brought forward from the previous year by the fund's actual investment return achieved during the year. The balance on this "account" at 31 December was £1.8 billion.

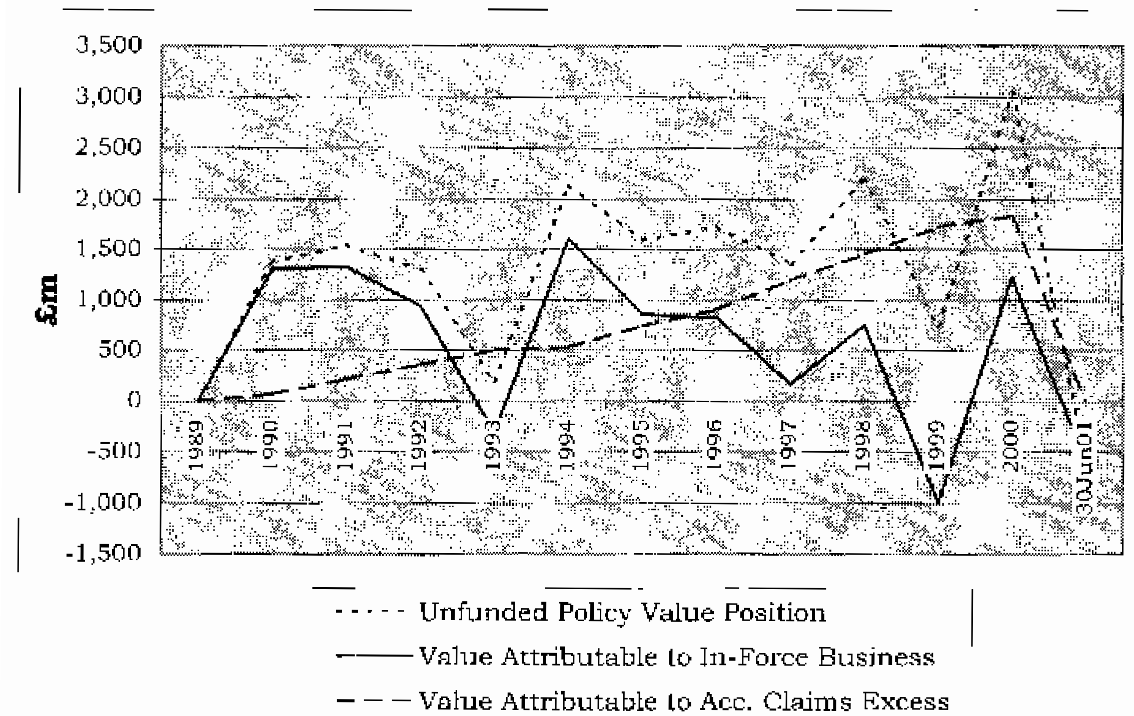
60. The amount of excess over aggregate policy values (column C) as derived in table 6.3 depicts a year-end position of the with-profits fund on the office valuation. The excess over asset shares (column D) is the difference between the two former columns and represents the year-end position attributable to in force policyholders. It is here the Society made attempts at "smoothing" when in 1993 and 1999 an "over-funded" position on in-force business arose which on the face of it appeared to place the fund (column C) in a near balanced position in those respective years.

61. The most fundamental deficiency in the Society's attempts to smooth was in its approach to claims. Claims on average continued throughout the period of review (above) to be paid out in excess of their asset share leaving the in-force business to restore balance. Smoothing consequently was not applied at a claims level, with the exception perhaps in the case of non-contractual claims where MVA's were applied from time to time at the discretion of the Society. Consequently the Society became heavily dependent on unallocated investment earnings on new and in force business

in its attempts to restore fund balance. The reality behind the Society's approach to smoothing lies not simply in the un-funded position but in its two constituent elements which reveal the extent to which the in -force business was encumbered by the Society's practice towards claims.

62. The FSA, in a letter to the inquiry, have expressed their view that the Society appeared to have operated and achieved a three to five year smoothing cycle on the basis that the fund was broadly in balance in 1989, 1993 and 1999. Their analysis would appear to have solely concentrated on, and by default accepted, the Society's year-on-year projected unfunded position while taking no cognisance of the fundamental realities behind this picture as discussed above.

Figure 6.11: Analysis of claims



63. Headdon's view in 1997 was not pessimistic. Among other comments in his August memo to Nash, he wrote:

> "6. I would not want to make too much of this. In particular one should note:
>
> (i) ...
>
> (ii) ... the short-term volatility of actual returns will tend to make the apparent smoothing cycle look considerably shorter.
>
> (iii) our business growth should give us less of a problem than most other offices.
>
> (iv) there is some evidence for (iii) in our highly competitive short-term results - other offices appear to be cutting back severely at those durations (although significantly higher sales costs may also be a factor).
>
> 7. This decade has been unusual and the with-profits system has had to be made to cope. There is no suggestion in the above that anything should have been done differently. The analysis does, however, give some insight into the effects of those unusual conditions and indicates the long-term cycles that need to be followed in broad terms."

64. However, I am advised that the problem was more fundamental. In a more normal system of bonus allocation there is the opportunity to review terminal bonus allocations in the light of circumstances current at the date of claim, taking account inter alia of policy duration and the history of financial returns to that point. In the Society's case the accumulation of terminal bonus allocations in policyholder communications introduced an element of inflexibility, with the result that aggregate proceeds could not be adjusted for all relevant factors at the date of claim. Headdon did not comment on the consequences for continuing and new business policyholders. The discussion related to the position of the fund overall. The emphasis on the camouflage effect of market volatility and high levels of new money was hardly helpful. And the resort to competitive position in the present context could be said to suggest complacency. It is clear that Headdon did attempt to redress the balance, but at the expense of continuing and new business policyholders. On a more realistic approach overall it might have been noted that 1989 was not in any real sense the beginning of a phase in a smoothing cycle, merely a point in a trend that had its origins in 1982.

July 2001 Cut in Policy Values

65. As 2001 progressed the Society became increasingly exercised by the difference between aggregate policy values and asset values. The old Board was superseded by a new Board at 31 March 2001. Inevitably, the newly appointed directors would have required time to assimilate the financial position they had inherited, and it would have taken time for them to arrive at a position in which they could take decisions. They had taken over responsibility for a business that had immediate problems, and it is understandable that for them the focus had to be on identifying the present condition of the fund and developing solutions to emerging problems. They were not pre-occupied with the historical development of that position, as I necessarily have been. Financial analyses and reports prepared for the Board were not well adapted to the inquiry's requirements. The Board was unwilling to permit investigators unrestricted access to current papers, and inevitably there was tension. It has not been possible for a full reconciliation to be made between the several sources of figures that have been uncovered in these circumstances. Presentations differed not simply in detail but more broadly. However, on the Society's internal figures, the projected position at 30 June on the 'interim' office valuation was set out in a draft report as follows:

Table 6.12: Interim position at 30 June 2001

	£m
With profits assets	24,320
Unrecouped strains etc	510
[Net assets]	24,830
Full value of liabilities	23,198
Accrued final bonus	6,858
[Aggregate policy values]	30,056

66. These figures reflect an attempt to roll forward the Society's office valuation figures as at 31 December 2000 using investment return (-4%) and policy value rollup rates (+4%) for the 6 month period. These projections however ignored other fund movements such as new money, claims and in particular profits realised from the sale process.

67. At a meeting of the Board on 27 June 2001, Nowell presented a paper on FSA returns, policy values and bonus rates. The Board agreed that the current position was not sustainable. Among the matters that the Board was concerned about were:

i. Policy values exceeded asset shares by approximately 10% at 31 December, and the position had deteriorated to approximately 20% currently; and

ii. Policyholders who were electing to retire and invoke a maturity claim were generally withdrawing cash in excess of asset shares even before allowing for the cost of any GAR. This resulted from over allocation of bonuses in the period before 1991 as well as later experience.

68. On the basis of the office valuation, the policy values were 121% of with-profits assets, and full value liabilities were 93½% of with profits assets. The difference related to accrued final bonus of £6,858m. The author of the report stated that in another office it would not be surprising to see some payouts at up to 120% of asset shares, especially for very long durations, but that the average would be much lower. It was also noted that other offices would tend to have more regular premium business and also new business to "dilute" the effect over time. Finally other offices would have an estate or excess capital so that the overpayment was covered by assets, if it came to it. The writer noted that the Society could be accused of representing to policyholders that their aggregate interest at 30 June was £30 billion when in fact it was only £25 billion. At 30 June 2001, the Society's office valuation reflected accrued terminal bonus of £6.9 billion compared to the Companies Act accounts comparable fund for future appropriations of £1.1 billion, which, all else being equal, would have indicated an inherent shortfall of £5.8 billion.

69. The report commented on recent factors that had affected the position. There were said to be three main reasons why policy values were too high:

"1. Since 31/12/99 interim policy value increases were 8% in 2000 and 4% up to 30/6/2001. Investment returns were +2.7% in 2000 and say -4% in 2001 to 30/6/2001. Part of the 2000 increase was used to pay for the GAR liability. Nevertheless in effect 8 + 4 - (2.7 - 4.0) % of the excess of policy value over asset shares arises from the period since 31/12/99.

2. With profits claims payments in 2000 were say £2.5bn. If we assume that they were overpaid by say 3% this would have cost about £75m. In 2001 claims in the 1st half might be also say £2.5bn, but with an overpayment of (6.3% + 2%) or £207.5m. This then explains another 1 % overall of the reduction in assets.

3. Lastly it was estimated that at 31/12/1999 policy values were about 3% above asset shares, with most of the overpayment being to pre 1990 premiums."

In table 6.10 the over-payment in 2000 was £59m. The difference is largely attributable to the inquiry's estimate of 2.4% overpayment compared with the report's assumption of 3%. As will appear later, claims to 31 July 2001 were considerably higher, at £3.4 billion, than the estimate to 30 June 2001.

70. The scope for over-payment, even with market value adjustments where they were applied, is apparent from the benefits structure, especially of older policies. The accumulation of bonus according to date of contribution was analysed as shown in table 6.13 overleaf. Policy values in older business were significantly increased by terminal bonus allocations intimated to policyholders and reflected in the office valuation.

71. A key feature of the bonus system introduced by the Society in 1989 was that a uniform smoothed investment return was credited to accumulated policy values regardless of the duration in-force of the policy. While the split between GIR, reversionary bonus and final bonus might vary depending on the policy structure, the same total return was added regardless of duration. This contrasted with the practices of many other companies with significant amounts of single premium business, where more flexible bonus systems allowed for variation according to duration in-force and financial experience over the relative periods. This flexibility

allowed inter-generational smoothing and enabled the company to avoid locking in payout patterns in the way the Society did from 1989.

72. The absence, or abandonment, of this flexibility meant that the Society could only bring aggregate payouts into line with asset shares by paying less than asset share on some policies. In practice, it would have proved easier in the short-run (given the absence of any requirement to reserve for final bonuses) to pay out above rather than below asset share. This would have constrained the Society's ability to reduce over-payments.

73. More generally, it is unclear on what basis the Society could ever have expected to have been able to operate without inter-generational transfers in the absence of flexibility to differentiate by duration. In *With Profits Without Mystery* it was acknowledged that each generation of maturing policies was dependent on capital provided by succeeding generations. Flexibility to differentiate by duration would have been necessary for such a system to operate fairly in the absence of an inherited estate. The Society's practice did not provide that flexibility, and, given its full distribution policy, over-payment on older duration business was the direct result.

Table 6.13: Analysis of Accumulation of Bonus by date of contribution

Single premium paid on:	Est. asset share after GAR costs (£)	Guaranteed fund (£)	Terminal bonus (£)	Policy value (£) (B)+(C)	Terminal bonus % (C)/(D)	PV as % of asset share (D)/(A)
	(A)	(B)	(C)	(D)	(E)	(F)
01.01.00	926	1,053	21	1,074	2%	116%
01.01.99	1,070	1,106	96	1,203	8%	112%
01.01.98	1,207	1,162	161	1,323	12%	110%
01.01.97	1,409	1,239	256	1,495	17%	106%
01.01.96	1,552	1,334	311	1,645	19%	106%
01.01.95	1,802	1,436	373	1,809	21%	110%
01.01.94	1,717	1,545	445	1,990	22%	116%
01.01.93	2,203	1,663	585	2,249	26%	102%
01.01.92	2,598	1,808	711	2,519	28%	97%
01.01.91	2,959	1,993	778	2,770	28%	94%
01.01.90	2,636	2,217	886	3,103	29%	118%
01.01.89	3,309	2,467	1,257	3,724	34%	113%
01.01.88	3,792	2,745	1,471	4,215	35%	111%
01.01.87	4,110	3,054	2,099	5,153	41%	125%
01.01.86	4,936	3,429	2,731	6,160	44%	125%
01.01.85	5,598	3,877	3,439	7,316	47%	131%
01.01.84	6,572	4,388	4,418	8,802	50%	134%
01.01.83	7,991	4,958	5,669	10,627	53%	133%
01.01.82	10,565	5,606	7,087	12,693	56%	120%
01.01.81	11,653	6,339	9,162	15,500	59%	133%
01.01.80	14,228	7,167	11,442	18,609	61%	131%

74. Table 6.12 produced an overall picture of the position at 30 June 2001. The Society was able to produce for the inquiry a more detailed assessment of the financial position of the with-profits fund based on the internal office valuation. These figures have been presented alongside the post policy value cut of July 2001 in table 6.15 below. The 30 June 2001 figured revealed an unfunded policy value

position of £4.4 billion some 19.2% in excess of available assets. This position formed the background to which the new Board responded by cutting policy values. This restored balance in the fund.

75. In July 2001 the new Equitable Board cut policy values by 14 or 16% depending on policy class. The appointed actuary at that time, Peter Nowell, carried out an analysis of the Society's position at 31 December 2000 in support of the need for a policy value cut. By 16 July 2001, when the cut was intimated, the Board had available up-dated market values that showed a continuing deterioration in the Society's position. It is not possible in the circumstances to reconcile all of the values relevant to the decision. However, the position was generally as indicated below. Leaving out of account the effect of the up-dated assets valuation, the reduction intimated on 16 July 2001 was valued at £4.9 billion (including a separate adjustment of with-profits annuity values of £630m). Of that sum £600m was said to represent over-recovery of accumulated excess policy values, on Nowell's calculations. The value written off amounted to £3.6 billion, or £4.3 billion including the with-profits annuity adjustment. The core data is summarised in table 6.14.

Table 6.14: Core Data for July 2001 Policy Value Reductions[21]

	£m
In-force business at 31 December 2000	
Pre House of Lords policy values adjustment [assumed roll-up rate of 9%]	29,167
less: Reduction in bonus rate to 0% for 7 months	(1,455)
Add: GAR Provision	1,500
Best estimate commercial cost	1,300
GAR Rectification Scheme	200
Revised policy values after adjustment for GARs	29,212
Terminations: 1 Jan 01 to 31 Jul 01	(3,363)
In-force business at 31 July 01	25,849
Growth for 5 months at interim bonus rate of 8% pa = 3.3% on £25,804m	851
Sub-total	26,700
14-16% policy reduction on 31 Dec 00 values - 16 Jul 01	(4,265)
With-Profits annuities adjustment: 16 July 01	(630)
Sub-total	21,805
Add: Revised bonus rate reduction	338
Bonus rate reduction to fund cost of GAR: pre 14-16% reduction	1,455
Bonus rate reduction to fund cost of GAR: post 14-16% reduction	1,117
Less: Revised cost of GAR	(243)
Guaranteed annuity provision: pre 14-16% reduction	(1,500)
Less: Guaranteed annuity provision: post 14-16% reduction	1,257
Aggregate Policy Values at 31 July 2001	**21,900**
comprising:	
Aggregate policy values	20,643
GAR provision – revised	1,257
	21,900

[21] See financial tables, table H.3.

76. The figures reflected in table 6.14 above have been extracted from Nowell's report to the Board as supplied to the inquiry. Nowell's opening value revised for the annuity guarantee adjustment was £312m more than that reflected in the office valuation in table 6.9: £29.2 billion as against £28.9 billion (the office valuation at 31 December 2000 including £1.5 billion for the annuity guarantees). The difference has two origins. Firstly, there was the net adjustment of £45m relating to the difference between the £1,500m GAR provision and the 'recouped' value from withholding 7 months of bonus of £1,455m. Secondly, Nowell's opening value of £29,167m was rolled up at an initial rate of 9%, later revised to 8% as correctly reflected in the Society's 2000 year-end office valuation. The effect was to reduce Nowell's value by £267m thereby reconciling this value to the corresponding with-profits liability value of £28,900m disclosed in table 6.3. The net adjustment is equal to the total difference of £312m.

77. The table presented the aggregate policy position at 31 July, by which time there had been further movements in both investment and policy values since 30 June. The inquiry was provided by the Society with information relating to its internal assessment of the with-profits fund at both 30 June and 31 July 2001. These figures have been presented in table 6.15 below.

Table 6.15: Internal with-profits fund valuation at 30 June and 31 July 2001[22]

Office Valuation Basis: With-profits fund	**30-Jun-01**	**31-Jul-01**
	£m	**£m**
Total investments (after net current assets/liabilities)	22,338	22,500
New business loan	494	-
Deferred development expenditure	16	-
Net assets	**22,848**	**22,500**
With-profits liabilities at full value	19,670	19,303
Guaranteed annuity provision	1,500	1,257
Face value of guarantees	**21,170**	**20,560**
Accrued terminal bonus	6,055	1,340
Aggregate Policy Values	**27,225**	**21,900**
Unfunded Policy Value Position	(4,377)	600
Aggregate policy values as a % of net assets	**119.2%**	**97.3%**

78. At 31 July 2001, after giving effect to the policy value cuts, accrued terminal bonus continued to account for a substantial proportion of realistic policy values. Nowell's estimates were reflected in a table that again analysed the asset shares attributable to £1,000 of investment over time: see table 6.16 opposite and compare table 6.13 above. Again, the table was qualified: it did not pretend to total accuracy. But it demonstrated that even after the cut in policy values the accrued terminal bonus was over 10% of policy value in all cases sold before 1990. In the case of contributions after January 1995, the cut eliminated all or most of the previously accrued terminal bonus, and, as a matter of arithmetic, in the last five years resulted in terminal bonus being expressed as a negative value, effectively reducing APV below guaranteed benefits.

79. The Board had undertaken that the guaranteed value would be paid as a minimum, notwithstanding the cuts, until terminal bonus became positive again. The office records could not, at that time, reflect the results of that decision. There was therefore implicit in the aggregate policy position at 31 July the need for a

[22] See financial tables, table H.4.

further redistribution of value[23]. Guarantees in excess of the reduced policy values on claims had to be met from the surplus available for non-guaranteed allocation, and so had to fall on the whole fund.

80. Nowell adjusted the £600m surplus brought out in his earlier exercise for variations in assets and liabilities values to reflect his views of additional factors that were not fully taken into account in the computation. He wrote off the new business loan included in assets, of £400m, £1 billion in respect of estimated overpayments, and added miscellaneous profits, substantially referable to part disposals of the business, of £590m. He increased the liabilities by £400m to allow for improvements in life experience over the mortality provisions made by the Society[24]. The surplus of assets over liabilities was reduced to under £400m.

Table 6.16: Estimated asset share per £1,000 invested

Single premium paid on:	Est. asset share after GAR costs (£)	Guaranteed fund (£)	Terminal bonus (£)	Policy value (£) (B)+ (C)	Terminal bonus % (C)/(D)	PV as % of asset share (D)/(A)
	(A)	(B)	(C)	(D)	(E)	(F)
01.01.00	927	1,056	(184)	872	- 21%	94%
01.01.99	1,070	1,109	(133)	976	- 14%	91%
01.01.98	1,207	1,165	(92)	1,074	- 9%	89%
01.01.97	1,409	1,242	(29)	1,213	- 2 %	86%
01.01.96	1,552	1,337	(3)	1,335	- 0%	86%
01.01.95	1,802	1,439	29	1,468	2%	81%
01.01.94	1,718	1,549	66	1,615	4 %	94%
01.01.93	2,204	1,668	157	1,825	9 %	83%
01.01.92	2,598	1,812	232	2,044	11%	79%
01.01.91	2,959	1,998	251	2,248	11%	76%
01.01.90	2,637	2,223	295	2,518	12%	96%
01.01.89	3,309	2,473	549	3,022	18%	91%
01.01.88	3,792	2,752	669	3,421	20%	90%
01.01.87	4,111	3,062	1,120	4,182	27%	102%
01.01.86	4,937	3,438	1,561	4,999	31%	101%
01.01.85	5,598	3,888	2,050	5,938	35%	106%
01.01.84	6,573	4,396	2,748	7,144	38%	109%
01.01.83	7,992	4,971	3,653	8,624	42%	108%
01.01.82	10,566	5,620	4,680	10,301	45%	97%
01.01.81	11,654	6,355	6,224	12,579	49%	108%
01.01.80	14,230	7,186	7,916	15,102	52%	106%

81. The position is shown in summary in table 6.17 on the next page. The table shows the position of the Society, at 31 July 2001, the nearest date to the reference date that is available, on a realistic basis, making allowance for necessary adjustments to the actuarial assumptions previously made to reconcile the figures appearing in table 6.15. The Society's position as presented in this table was one of marginal solvency. Without the cut in policy values the Society would have been insolvent on a realistic basis.

[23] In practice, this would not happen. It appears more likely that later allocations of terminal bonus would be applied to reduce and finally eliminate the negative terminal bonus factor. In that event, the affected policyholders would see no positive benefit from terminal bonus allocations until their individual policy values exceeded the guarantees.

[24] Compare chapter 5, paragraph 121.

82. Contributory factors to that position were over-allocation of benefits especially by meeting claims on a full value basis, or with inadequate MVAs; failure to reserve for annuity guarantee liabilities; tardy implementation of mortality adjustments; and including 'aspirational' assets in the computation of realistic surplus. The adjustments reflected the need to adjust the Society's approach to the realities of the position at July 2001. The with-profits fund was closed to new business. The prospects of recovering the new business loan in the ordinary course of managing the notional administration company in any real sense were materially reduced[25].

Table 6.17: Summary of adjustments

	£m
Assets:	
Net Assets	23,710
Less: new business loan - write off	(400)
Less: Estimated previous overpayments	(1,000)
Add: Miscellaneous profits	590
Net Assets	22,900
Liabilities:	
With-profits liabilities	20,643
Add: Improvement in life expectancy	400
	21,043
GAR provision	1,257
Aggregate policy values	22,300
Surplus	600

83. The adjustment for previous over-payments was a round-sum allowance. It is not clear that it was computed on the methodology developed by Headdon, nor indeed precisely what claims it related to, but it reflected the inability to recover from previous claims the excess allocations crystallised on payment. While the value of over-payments in July 2001 is undisclosed, it appears to be clear that some part of the £1 billion must relate to claims arising before 31 December 2000. Using Headdon's methodology for assessing claims to 1996 and extrapolating this forward, the inquiry has aggregated the 'current year claims excess' column in table 6.10 for the years 1989 to 2000 which gives a total over-payment of £889m. This calculation ignores the opportunity cost of investment growth (as incorporated in Headdon's calculations but not taken into account by Nowell), which is reflected in the accumulated claims excess column of the table that derives a balance of £1.8 billion.

84. The over-payments to 30 June 2001, on the level of payouts assumed, was £207.5m If the same rates were applied to the actual withdrawals to 31 July over-payments on claims for the part year would have arisen to some £279m. This together with the aggregated total of £889m gives a value somewhat in excess of the £1 billion over-payment estimated and used by Nowell in his calculations[26].. Using Headdon's claims methodology the inquiry's estimate of over payment to 30 June was £387m decreasing marginally by an estimated £5m to 31 July due to the policy value cut.[27] The difference is largely attributable to the inquiry's application of actual excess rates which are nearly double the projected rates used by Nowell.

85. Improvements in life expectancy were reflected in the round-sum allowance of £400m. I have referred to the failure to provide specifically for increasing mortality risk as an incident of the failure properly to reserve for annuity guarantees. But it

[25] It has been pointed out that 'profits' would arise from the unwinding of the existing book, and it has been suggested that this comment overlooks that point. The comment is not constrained by actuarial practice, however. In general terms there is a limit to the number of applications that can be made of the margins implicit on in-force business.

[26] Compare paragraph 68 above: a precise reconciliation has not been possible.

[27] See financial tables, table H.2.

was a problem affecting the whole of the Society's older annuity business, in possession and deferred. The Society was tardy in adopting up-to-date mortality tables, preferring to adjust out-dated tables in a way that failed fully to reflect mortality trends. In his report to the Board dated 11 December 1998, Headdon is reported to have said:

> "The Managing Director and Actuary drew attention to his report on the breakdown of profits from miscellaneous sources. In particular he commented on the favourable position on mortality profits for assurances and the losses on annuitants' mortality offset to some extent by increasing interest and expense margin profits on that class. The loss on mortality stems from older business on the books, with mortality experienced for this business having improved greatly. Newer business for contracts of managed and unit-linked annuities for example allows for more modern mortality data, and monitoring of experience will continue."

It is clear that the problems associated with the older annuity business were recognised, and adjustments were made to valuation assumptions from time to time. I have not considered it justifiable to instruct complex actuarial valuations of the whole business to assess the cost the Society. Nor have I thought it appropriate to make an attempt to obtain advice on Nowell's ball-park figure of £400m for improving life expectancy. Since the figure was accepted by the Board at the time, I have accepted it as sufficiently indicative of a major problem for present purposes.

86. It would be inappropriate to suggest that Equitable alone had problems with improved longevity in the annuity market. As with many of the Society's financial problems, its difficulty was a function of the narrow free assets position maintained. Other offices had problems with lighter mortality. But with substantial free assets (in the sense of excess assets over guaranteed liabilities) they had scope to manoeuvre. In the case of Equitable each additional marginal strain on solvency was a major risk because of the lack of resources that resulted from over-allocation of bonuses and resulting over-payment on claims.

Table 6.18: Six months ended 30 June 2001

	£m
Interest and dividend income	605
Realised investment gains	1,942
	2,547
Movement in unrealised investment (losses)	(3,473)
	(926)
Investment management expenses including interest	(36)
Investment return for the period	(962)

87. For the six months ended 30 June 2001, the Society's investment experience was summarised in the interim accounts as shown in table 6.18. In the directors' report on the interim accounts it was explained that the reduction was necessary to bring aggregate policy values into line with the value of assets. In his report as chief executive on the 2001 Companies Act accounts, Thomson explained the cut:

> "Policyholders departing with more than their share of the fund damage the fund for those who remain. This can occur from time to time in with-profits funds, but is normally 'smoothed' out over many years by using a combination of new premiums, 'free assets', and periods of stronger market performance to offset falls in the market.
>
> The lack of available reserves and closure to new business meant that these options were not available to Equitable Life and the flexible retirement dates on existing policies meant that 'normal' smoothing could not operate.
>
> This poor state of the fund, exacerbated by the significant decline in the stockmarket, was clarified by the financial review that we commissioned. Upon seeing the results, we immediately took the necessary but drastic action of

> cutting policy values in July to bring them in line with underlying asset values. That action, plus the use of the financial adjustment for those surrendering their policies early, meant that we stemmed the haemorrhaging of excessive payments out of the fund."

This is not the moment for a critical review of Thomson's explanation of smoothing in the context of the Society's practice, but he clearly identified the two factors that required action: the haemorrhaging of excessive payments out of the fund, and declining investment values. The latter factor was quantified at 30 June 2001. The former can be derived arithmetically. Treating the investment income as pure profit, the capital losses did not exceed £1.5 billion by the reference date for the reduction in policy values. On this approach, the excess of policy values over assets that emerged from the office valuation would not have been fully recovered by the reductions net of the £600m that the actuary brought out as initial surplus. But differences in values of the order involved, given the uncertainties of valuation practice, are not material. Having regard to the whole information available, the balance of the policy cuts in excess of the investment losses can be related to the previous over-allocation of bonus.

88. Given the potential for smoothing generally, perhaps the most significant figures in table 6.10 are those relating to excess claims values. To the extent that claims had been recognised, on maturity or earlier withdrawal from the with-profits fund, the Society had no flexibility to alter the adverse impact of the excess credits. Whatever could be done to claw back earlier excess allocations in the case of in-force with-profits policyholders (whether all or part of the excess had accrued to their benefit or not) the liabilities on settled claims had crystallised, and become contractually due, at a value in excess of APV, resulting in overpayment that permanently impacted on the Society's financial position. The excess could be recovered only by withholding future surpluses from distribution to the remaining with-profits policyholders of the Society or by some more drastic action such as cutting policy values for those who remained participants in the fund at the time that action was taken[28].

89. The effect of the adjustments of July 2001 was to impose on the current participators in the with-profits fund a charge that reflected part of the Society's history of over-allocation between 1987 and July 2001 as well as the residual over-allocation implicit in the policy values of in-force business. Some part of the charge related to over-allocations credited to policy values of continuing policyholders, but the balance related to over-allocations on past claims. The current policyholders bore the cost of excessive benefits in the past whether or not they had enjoyed those excess benefits. The cost of excess allocations was inevitably passed on to the present generation of policyholders: the policy cuts attributed the cost of the cuts to those who happened to be with-profits policyholders at the critical date in July 2001. Apart from the losses attributable to market movements by June/July 2001, this was the result of sustained over-allocation and sustained over-distribution on claims[29]. As Headdon had commented, it was probably never the case that a 'normal' smoothing policy was implemented.

Maxwellisation representations

90. In the course of maxwellisation, FSA submitted material to the inquiry that challenged the approach adopted to the analysis of the society's realistic position.

[28] It has been suggested that this presentation is wrong. The explanation offered is that excess claims values are money lost, and reduce the capital available to the organisation. But the loss does not have to be made good. All that the actuary can do in setting on-going bonus rates is to make the best of the current position. As I understand it, the result is the same: on-going policyholders are disadvantaged by and to the extent of the loss. The approach I have adopted is admittedly less effective in removing the actuarial footprints from the snow behind.

[29] As with the last paragraph, this approach has been challenged, and it has been suggested that the comment is true only to the extent that the fund was weakened and that the new policy values reflected the assets then available.

The material compared the investment return on the with-profits fund, less an allowance for expenses, with bonus allocations over the period 1987 to 2000. The percentages for returns, expenses and allocations were accurate or, where estimated, within acceptable ranges. The Authority applied a smoothing assumption, for a three year cycle, and appeared to present the results as evidence for the view that there had been no 'over-bonusing', in its preferred terminology.

91. It is, perhaps, best to test the approaches by reference to real circumstances applying at a time when there was no market value adjustment in operation, in particular mid-1997. For 1996 the Society had an actual investment return of 10.7%. It allocated 10%, and so net of expenses of about 1% (the FSA assumption) there was a fairly precise correlation between yield and return to policyholders. 4% was declared reversionary bonus. For a particular policyholder, the result was intimated as follows:

Table 6.19: Example of policyholder benefits at 31 December 1996

	Guaranteed value	Non-guaranteed final bonus	Total value
Value of benefits as at 31/12/95	£8,478.65	£12,628.56	£21,107.21
Benefits purchased during 1996	£0.00		£0.00
GIR and bonus declared in 1996	£559.59		£559.59
Change in final bonus in 1996		£1,551.13	£1,551.13
Value of benefits as at 31/12/96	£9038.24	£14,179.69	£23,217.93

Ignoring adjustments for the final few months for the sake of simplicity, and the actual date of the transaction, it can be assumed that the policy became a claim in the early summer. There was no market value adjustment at that time. (The last case of a market value adjustment on the previous basis was made in March 1997.) The claim value was over £23,217.93. The ratio of aggregate policy values to assets at market value was 111%. The policyholder's benefits at claim were some £2,554 over the relative asset value. That sum represented capital lost to the fund on his claim. The overall percentages relating returns to allocations to policyholders fail to take account of the movements in the fund capital that actually took place. For business of longer duration, this pattern was repeated at least throughout the 1990s. Due to over-payment on claims, reflecting over-allocation of bonuses, there was persistent capital erosion. That was the reality of the situation.

92. FSA's calculations were arithmetically correct, but the analysis was somewhat superficial compared to the reality of the Society's practices, which distinguished its terminal bonus operation from those of other insurers. The pure arithmetical exercise, based on comparisons between actual and allotted returns over time, which does not extend to further analysis of both the asset and liability values to which these factors are applied, does not take account appropriately of or reveal deeper issues.

93. While the FSA's approach might be appropriate in other instances, it is flawed in the case of the Equitable, as it does not recognise the Society's sustained practice over a long period of paying out contractual claims in excess of the underlying asset share. The impact of this practice was an excessive erosion of the fund's asset base (in comparison to the underlying liabilities) thereby diminishing the fund's ability to earn in absolute value terms. Excess claims paid out represented value forever lost to the fund. Value needed to be clawed back from future earnings on both in-force and new business creating a significant encumbrance on the fund. For "smoothing" fully to take effect in this context claims had to have been paid out for at least part of the smoothing cycle below asset share, thereby restoring balance at this level.

94. Explaining the methodology they had applied to rationalise the Society's approach to smoothing, FSA commented that they had made the following assumption:

"In calculating these bonus rates, we have not made any allowance for the fact that firms might adjust payouts to rebalance overpayments (historic or projected) by seeking to pay maturities at a level other than 100% of asset shares. In practice, if a firm using this technique had a significant deficit on this smoothing account, it could reduce the amount of bonus paid on maturity (compared to the smoothed asset shares derived from the averaging method) by targeting less than 100% of asset shares."

As is demonstrated by table 6.10, this was not an approach used by the Society and the reference made to the practice of other offices only underscored the impression created by the FSA analysis that sufficient assessment had not been made of the realities behind the actual management of the fund.

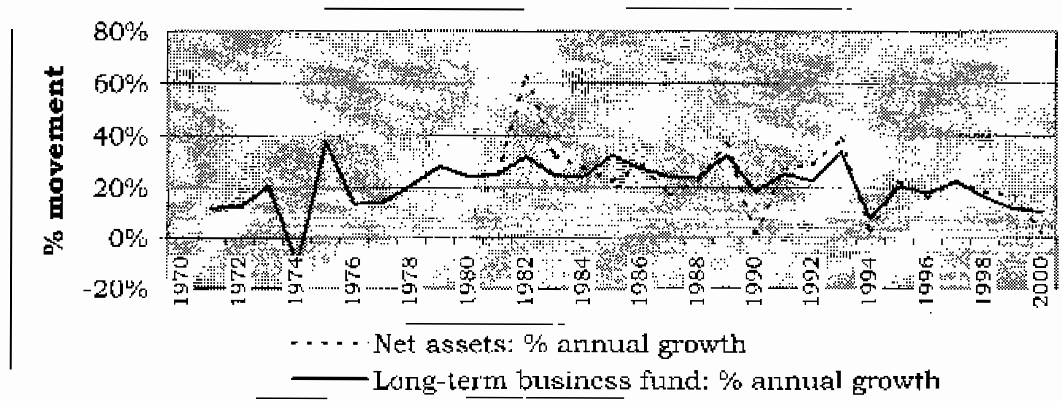
95. The fund erosion through excess claim payouts rose to an estimated £1.8 billion by 2000. Therefore while policy values were being rolled up at the Society's allotted return, the consequential eroded asset base in support of these values was changing with actual investment experience. The effect was that the asset base needed to work harder to generate excess earnings required to restore balance in the fund. In effect the Society operated on a negative estate basis without effective inter-generational transfer. Over time an unsustainable and unfair position emerged that new and existing business had to be made to support.

Presentation in Companies Act Accounts

96. The presentation of the Society's performance in the Companies Act accounts has been discussed in chapters 3 to 5. The impression communicated was of sustained growth in key areas over time. But there were some indications in these accounts that rates of growth had begun to fall over a long period.

97. The annual growth in the technical provision and investment values published in the statutory accounts, in percentage terms, is reflected in figure 6.20:

Figure 6.20: Analysis of growth[30]



Investment values mirrored the value of technical provisions until 1982 when the accounts first showed investments at market value. Apart from 1973-74, the rate of growth in technical provisions accelerated from 14% in 1971 to 25% in 1982. The reduced market value of investments in 1973-74 resulted in a high running yield on the fund, use of which in the valuation process automatically reduced liability valuations at that time. The dramatic recovery of investment values in 1975 reversed this process and led to correspondingly increased liabilities in that year. In 1982 the investments were entered at market value throwing up an apparent gain reflected in the peak of investment growth. Until that time taking credit for capital appreciation only to the extent required to support revenue surplus kept the disclosed asset value and technical provision in close relationship to each other.

[30] See financial tables, tables C.1 to C.4.

98. From 1982 the scope for discrepancy between the liabilities and technical provisions increased. The greater degree of variation in investment values, reflecting the volatility of equity markets, the more easily are the peaks and troughs identified. In the period 1983 to 1993, the fall in the rate of growth of investment values in 1990 reflected the first major collapse of equity markets at the year-end since 1974. 1994 reflected the same phenomenon as 1990. Rates of growth in net assets and in the long-term business fund began to decelerate in about 1990, after a period between 1980 and 1990 when, on average, the rate of growth had been relatively flat. A rough line graph through the technical provisions values shows that over all the rate of growth was more or less level during that decade. Over the 1980s the Society had fought to maintain, and on the whole had succeeded in maintaining, competitive position. But it had done so at the cost of weakening its reserves. By 1990 the weakness of its balance sheet was well advertised: *With Profits Without Mystery* adopted the inevitable outcome of this approach as policy. Having no estate, maintaining no estate was advertised as the positive policy of the Society. Discussion of the paper reflected widespread opinion in the actuarial profession that the Society would be vulnerable to equity market shocks because of the lack of free assets with which to buffer any sudden falls in value.

99. In general, the position brought out on the realistic office valuation basis was not reflected in the Companies Act accounts. As discussed elsewhere there was no obligation on the Society to include accrued terminal bonus in its technical provisions. However, the information available to me about industry practice indicates that it would have been appropriate to recognise a value for likely levels of terminal bonus in the investment reserve or fund for future appropriations. Equitable did not do so after about 1986 or 1987. Thereafter, in the case of the Society, the sums held on investment reserve, and from 1994 in the fund for future appropriations, were never sufficient to cover the accruing terminal bonus values intimated to policyholders.

Table 6.21: Movement in Reserves and Bonus

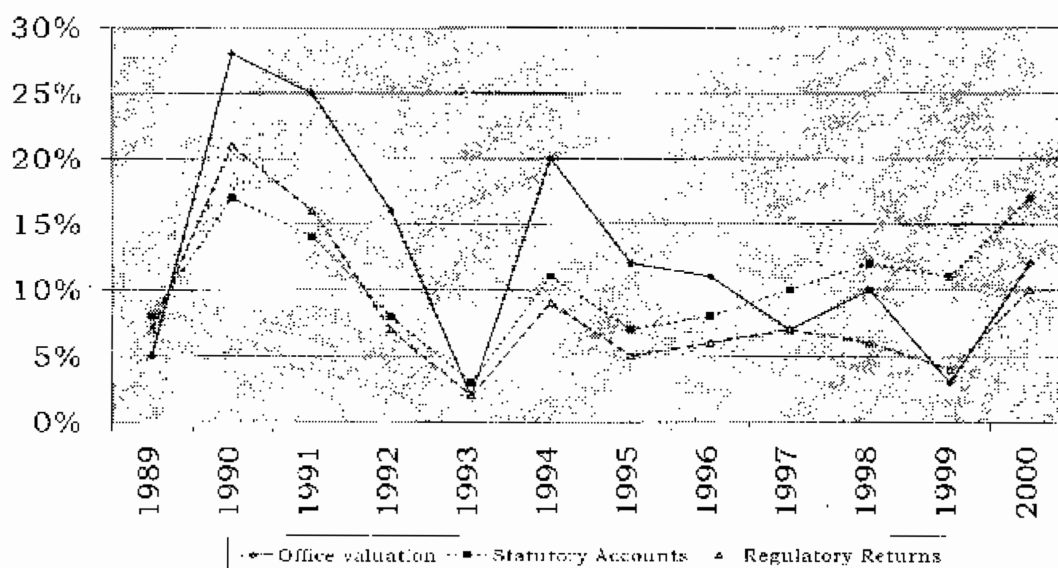
Year	Reserves[31]	Reserve movement	Terminal & interim bonus paid	Accrued terminal bonus
	£m	£m	£m	£m
1989	1,001	383	100	1,402
1990	210	(791)	154	1.422
1991	375	165	152	1,542
1992	935	560	168	1,604
1993	1,741	806	165	2,057
1994	1,174	(567)	173	2,343
1995	1,705	531	246	2.599
1996	1,733	28	299	2,897
1997	2,176	443	388	3.845
1998	3,025	829	475	4.620
1999	4,841	1,816	508	6.008
2000	2,311	(2,530)	544	5,933

100. The movement in its reserves year on year, set out in table 6.21 above, shows that there was no relationship between the growing values of terminal bonus payments or accrued terminal bonus on the one hand and movement in the

[31] Investment reserve/fund for future appropriations.

reserves. The movements on the account bore no relationship to any pattern that could have reflected an accounting policy of relating the sums held to the sums required to reflect the terminal bonus values involved. Movements in reserves were consequential rather than structured. There is no data available to compute on an acceptable basis the amount that would have been recognised in the Companies Act accounts if the Society had attempted to carry out such an exercise. The sums would not have been likely to be the same as those recognised in the office valuation. But those sums were the sums intimated to policyholders and provide at least an initial point of reference.

Figure 6.22: % Excess aggregate policy values to assets



101. The arithmetical results of aggregating the amounts intimated to policyholders with the liability valuations on the three relevant bases are summarised in figure 6.22 above. The values cannot be represented as accurate, but the figure gives some indication of the relative impact of introducing accrued terminal bonus.

102. In a few life offices stochastic modelling of future risk was practised from the later 1980s. Scottish Widows' approach was the basis of a paper by its appointed actuary published in 1989. Professor Wilkie was employed by Standard Life at the time he developed his modelling techniques in the 1980s and that office tested his proposals. I understand that in the event Standard Life did not adopt stochastic modelling generally. In their case, the test of Professor Wilkie's model showed that the worst-case scenario reflected actual experience in 1973-74, and deterministic modelling on a worst-case basis was adopted using the characteristics of actual experience at that time throughout the 1990s. However, even against that background, the office recognised the value of stochastic modelling as the annuity guarantee issue emerged. The office recognised the liability to meet the guaranteed annuity obligations it had undertaken and reserved on that basis.

103. These two examples perhaps reflect fairly extreme sophistication in the adoption and application of statistically-based techniques in the early 1990s. Implementation of statistical and mathematical modelling techniques did not become standard practice across the industry at that stage. Over the decade as a whole it became more widely recognised that more sophisticated modelling of probable future experience was necessary for proper management of substantial with-profits funds. All of the major consulting companies have developed programmes for use by clients. The FSA has encouraged the trend more generally. And academic interest had developed. Those who offered the inquiry assistance included Professor Waters and Professor Wilkie of Heriot-Watt University and Professor Haberman of City University, London. Professor Wilkie has continued to

refine the model that was available in the 1980s. Professor Haberman and his colleagues have been engaged in a study of a model that will use pre-determined standard criteria modulated for current market and other experience with a view to simplifying modelling methodologies. Others, including consulting actuaries, are pursuing research with the same objectives.

104. However, in one form or another mathematical techniques were available to provide a statistically-based assessment of future risks and to support current reserving and bonus policies. In common with many other offices, Equitable rejected such methodologies, and the Society's actuaries were entitled to do so if an alternative and satisfactory method were applied. But the method adopted, of deterministic modelling from current and immediate past experience over a rolling period of three years, was short-term, and lacked robustness of character. So far as the inquiry's investigations have shown, risks of adverse scenarios were not adequately tested or reflected in the approach to recognition of future terminal bonus in quantifying necessary general reserves, as distinct from technical provisions for liabilities. The Society's inadequate approach to scenario or stress testing was reflected in its general lack of robust financial condition reporting.

105. The balance sheet position was, however, affected by other factors at critical periods. Until 1989 the Society's gross premium valuation was calculated using the same rates for the projected bonus and for the valuation interest assumed. In combination these resulted in liability values for the Society's characteristic RSP pensions business that were or approximated to the full face value for contractual liabilities reflected in the internal office valuation and in the Companies Act accounts. 'Face value' represented the aggregate of the guaranteed sums assured and any attaching reversionary bonuses. This practice had been followed over many years. In the material period RSP pensions business accounted for a sufficiently high proportion of the total in-force business to be reasonably representative of the business as a whole.

106. Between 1990 and 1997 the Society valued its RSP business at less than the face value of the benefits under the policies. The Society achieved the lower values by introducing a difference between the valuation interest rate and the gross bonus rate assumed in the principal bonus reserve valuation. The respective rates and the value of the differences are set out in the table 6.23.

Table 6.23: Differential valuation interest rate[32]

Year	Valuation interest rate	Gross bonus rate assumed	Difference (Margin differential)	Estimated Value	Discount ratio
1989	8.75%	8.75%	0.0%	-	100%
1990	10.0%	8.75%	1.25%	£498m	85%
1991	10.0%	8.75%	1.25%	£637m	85%
1992	10.0%	8.75%	1.25%	£773m	85%
1993	7.25%	7.0%	0.25%	£178m	97%
1994	5.5%	4.0%	1.5%	£832m	88%
1995	5.0%	4.0%	1.0%	£714m	91%
1996	4.75%	4.0%	0.75%	£535m	94%
1997	4.0%	4.0%	0.0%	-	100%

[32] See financial tables, table E.3.

107. The reductions in the cash value of the liabilities, set out in the penultimate column, were those reflected in the Companies Act accounts. In 1990, a year of substantial real losses in market value, the change of assumption generated distributable 'profits' that supported a bonus allotment that would otherwise have been possible only by a further material reduction in the investment reserve. In 1990 the result of the interest rate differential was a one-off release of surplus from the value of in-force business. There was a similar release in 1994, when the pattern changed and again there was a significant increase in the differential. In other years, when this form of discounting was at the same level as in the previous year, the method resulted in the early release of surplus from new business. In each case discounting by this method inflated the amounts available for distribution by reducing the valuation of liabilities.

108. The difference between the valuation interest rate and the bonus rate assumed in the valuation was effectively a measure of the strength or weakness of the valuation basis. While the valuation interest rate was higher than the bonus rate, the resulting liability valuation was reduced to below current face values. The Society relied on the expectation that there would be surplus income in the future to make up the difference. If, in the event, the Society failed to achieve the necessary surplus income, it would be forced to cut policy values at some stage to recover the shortfall. A weak position was therefore created. If the valuation interest rate were lower than the bonus rate, the implication would be that the office expected to receive income from 'free assets' or an 'estate' that it could distribute in addition to the returns on the assets covering the with-profits fund. That would be a position of strength. The greater the difference of the valuation interest rate over the bonus rate, the weaker was the resulting valuation. The values in the table make allowance for rolling up the bonus rate and the investment return and discounting in the years in which they applied to provide a better fit between reserves and the face value of the benefits than would have been obtained by using the society's published valuation ratios. In 1997 the Society reverted to the practice of valuing liabilities using a common rate for bonus and valuation interest.

109. There was no explicit guidance from GAD on this issue before 1994. From the late 1980s there were indications from GAD that offices were expected not to hold reserves for single premium business that were significantly below the accumulation of the premiums paid. At an Institute seminar in 1987, on 'Life Office Valuations – UK With Profits', of which Ranson was chairman of the programme committee, George Newton of GAD expressed GAD's view to that effect. In 1993, William Hewitson of GAD contributed to the discussion on a paper 'Unitised With Profits – Gamiel's Advice'. He specifically referred to GAD's concerns about companies holding reserves for single premium policies that were significantly less than the premiums paid. In 1994 the new regulatory requirements for valuation of liabilities with reference to PRE were typically interpreted as requiring reserves to represent at a minimum the premiums paid, less a reasonable deduction for expenses, accrued with investment earnings to the date of the valuation. There were further developments in 1997 that reinforced the trend. In the case of an office such as Equitable, where recurrent single premium pensions business was sold primarily as an investment product, under the 'managed fund' approach and as reflected in policy conditions and related literature after about 1986, policyholders' reasonable expectations would not have been met by a reserving approach that applied a portion of new contributions to the generation of surplus for allocation to others.

110. In this, as in some other areas, it has not been possible to obtain unequivocal expert advice on the propriety of the Society's conduct: actuaries have proved singularly reticent in criticism of fellow-professionals. The lack of regulatory guidance until 1994 takes one some way in explaining this attitude: without firm rules or well-defined principles there was wide scope for individual opinion and practice and an inadequate basis for criticism that would have been robust in the face of a hostile reaction. The conclusions of the consulting actuaries to the inquiry were:

"In summary, Equitable does appear to have followed the valuation regulations as they existed at the time. Also, it did not take credit for margins on future premiums that it might reasonably have expected to receive, and it did appear to develop its approach from 1997 in line with emerging guidance and industry practice. However, in our view, it would have been consistent with good actuarial practice for the Society to hold reserves at or close to the full value of the unitised with profit benefits. The discounting of the benefits between 1990 and 1996 does not appear to have been entirely consistent with the developing practice and principles at the time."[33]

111. It is not for me to form any view on the professional propriety of the conduct of the Equitable actuaries. That would be a matter for their professional bodies and may be dealt with by them at some stage. It may be appropriate to note that paragraph 2.3 of GN8, from 1994 onwards, mentions that the appointed actuary would be expected to make investigations in order to be satisfied that the long-term fund was able to support a proper level of future terminal bonus having regard to the bonus smoothing policy followed by the office. However, what is material for present purposes is that, over a period of particular strain, a mathematical expedient was selected and applied that had the effect of contributing to distributable profits when, from the point of view of a non-technical observer, the Society was over-allocating relative to its available resources.

112. The provisions for annuity guarantees in the Companies Act accounts were based on an erroneous view of the law, as decided in *Hyman*, until 2000. Subject to that, there is no basis for criticism of the amount included. The office valuation provision of £50m reflected the Society's assessment of the liability on a realistic basis on the assumption that the Society was entitled to apply the differential terminal bonus policy as envisaged. On that approach, a few policyholders only would have been entitled to the benefit of the annuity guarantee on the basis of guaranteed benefits that exceeded in value the cash equivalent of the relative current annuity reference value. Of those some proportion would have preferred the more flexible benefits available on more modern contracts. In the Companies Act accounts the provision was increased by a factor of four. On a true and fair reporting basis, increasing the realistic office provision by a factor of four was clearly sufficient, assuming that the Society's differential terminal bonus policy had been valid. One would not have expected more to be set aside on that hypothesis. The legal advice received by the Society in 1997 and subsequently during the *Hyman* litigation was strongly supportive of the position that had been adopted. However, with the benefit of hindsight it is seen that the provision was inadequate at all material times: it was zero until 1998. An appropriate provision would have reflected the internal assessment of cost of at least £1.3 billion from 1998, and progressively increasing provisions leading to that sum over the period from 1993, accelerating in value from 1995. There would have been no need for a rectification scheme, but at least some part of the £200m would have added to the total provision.

113. In relation to claims, the Companies Act accounts reflected the cash costs arising from contractual liabilities that had previously been included in the technical provisions, in marked contrast to the treatment of terminal bonus. This reflected the view that, until paid out, terminal bonus had no reckonable value for accounting purposes. That was predicated on the underlying view that, notwithstanding the intimation to policyholders of the accruing terminal bonus on their policies, terminal bonus was instantly, and without reference to current and projected financial circumstances immediately liable to be withdrawn at the absolute and unqualified discretion of the Board. I shall deal with the realistic position later in discussing policyholders' reasonable expectations. At this stage it is sufficient to note that the practical consequences of the application of this view were that there was no recognition of any liability for terminal bonus on claims expected to arise after the

[33] Other actuarial comment has taken a different line and emphasised the lack of any reserve for the guaranteed annuity option.

balance sheet date, even in respect of the period ended 31 March following the balance sheet date during which terminal bonus would be paid in terms of a resolution of the previous February that had been intimated and described in written communications to policyholders and incorporated into the benefits statements that had been in their hands for nine months, and in many cases had been reflected in projections of benefits made in connection with impending retirements in the new year. In my opinion, the view that technical provisions were not required was taken to an unrealistic extreme that avoided a rational assessment of the reality of the Society's position.

114. In relation to assets, the Companies Act accounts were more conservative than the office valuation in minor respects. Provisions for deferred acquisition costs in and after 1994 were significantly lower than the relative new business loan values included in the office valuation. Further, development expenditure was charged to revenue as it was incurred, so that there was no equivalent in the Companies Act accounts of the deferred development expenditure asset reflected in the office valuation.

115. Therefore there were three major factors that contributed to the picture painted by the Companies Act accounts appearing more favourable than the realistic office valuation, and two minor factors that mitigated the impact. Members of the Society would have understood that terminal bonus was not provided for. But the amounts were not disclosed by the published financial statements, and members would not necessarily have understood that accruing terminal bonus of the aggregate values involved, growing over time, was not reflected in the accounts in any way, and in particular that the investment reserve, later the fund for future appropriations, was insufficient to cover in aggregate the amounts they had been told were prospectively available for non-guaranteed terminal bonus.

116. In relation to the valuation interest rates, there was intimation in the 1990 accounts that there had been a change. The president commented:

> "In accordance with the Society's Articles and Insurance Company legislation, the Society's Joint Actuary (who is the Society's Appointed Actuary) carried out a valuation of the assets and liabilities of the Society as at 31 December 1990. In the light of the income earned on the fund and having due regard to prudent actuarial principles, the liabilities were valued at a higher rate of interest than was used a year earlier. The effect was to reduce the value of the liabilities. As a consequence of that there was no need to transfer any part of the investment reserve to revenue account in order to meet the cost of declared bonuses or the cost of terminal bonuses on policies paid out during 1990..."

The statement was less than comprehensive: it did not disclose that the Society's rates of bonus projection remained the same, nor that the result depended crucially on applying the increased interest rate to write down values on a differential basis that differed materially from earlier practice. But there was sufficient information to have led a reader to ask in greater detail what had been done and so supplement his knowledge of the actuarial methodologies that had been applied. The accounts themselves would not have informed the reader of the extent of the release of profits generated by the actions taken. Similar information was not given in 1994.

117. The president's comment had effectively informed members that the change in the valuation rate of interest had enabled the cost of declared bonuses to be met without appropriation of capital appreciation. That set the context for the selection of the rate: it was done to generate profits for distribution at a time when the Society had been weakened by adverse investment experience. The Society strengthened the valuation over the period to 1993, reverted to the weakened basis in 1994 when there was another market collapse, and only achieved full restoration of its previous position in 1998. Throughout that period the differential had supported distributable profit at higher levels than would otherwise have been possible. Guaranteed benefits were added to policy values on this basis, and payouts on claims were inflated as a result of the total allocation reflecting the amounts

released. The Society needed a sustained rise in market asset values to restore the position. In the end that happened over a period until 1999, only to lead to a further collapse.

118. In combination, failure to recognise accrued terminal bonus and the generation or support of distributable profit by the interest rate differential with relatively high rates of declared bonuses, made a significant contribution to the weakening of the Society during the 1990s.

Presentation in the Regulatory Returns

119. In the Society's regulatory returns, the relatively high rates of interest assumed between 1990 and 1997 were reflected in the liability valuation: see table 6.24 on the page opposite. I am advised that the rates tabulated were within the regulatory limits, though at the top end of the permitted range. This resulted in a weak valuation, but there can be no objection to that in absolute terms. What the valuation regulations permitted was permitted. It may be more important to understand why a valuation assumption should be selected at or near the extreme of a permitted range. There may be good reasons for selecting a high rate and valuing liabilities at the lower end of the permitted range: investment flexibility may be enhanced on current regulations, and obtaining increased investment freedom might well be a legitimate objective. Even in such a case a weak principal liability valuation increases the need for prudence in the use of adjustments of the primary valuation. Where the motivation is related to the presentation of what is inherently a weak financial position, the assessment of the prudence of the approach becomes more critical.

Table 6.24: Unitised with-profit pensions

Year	Gross Premium Basis		Net Premium Basis	
	Valuation interest rate	Movement	Valuation interest rate	Movement
1989	8.75%	0.00%	5.00%	0.00%
1990	10.00%	+1.25%	7.25%	+2.25%
1991	10.00%	0.00%	6.50%	-0.75%
1992	10.00%	0.00%	6.50%	0.00%
1993	7.25%	-2.75%	4.50%	-2.00%
1994	5.50%	-1.75%	5.75%	+1.25%
1995	5.00%	-0.50%	5.25%	-0.50%
1996	4.75%	-0.25%	5.00%	-0.25%
1997	4.00%	-0.75%	4.25%	-0.75%

120. It is appropriate to note, again in contrast to the realistic office valuation, that the regulatory statement adopted a more prudent approach to certain of the assets taken into account internally, such as deferred acquisition costs and deferred development expenditure. These were not recognised as admissible assets, and, although the sums were relatively small at critical times, the result was a more prudent approach to determining regulatory surplus.

121. Turning to factors that require or may require adjustment to the published picture, the first, and the most readily accessible, is the failure of the Society to make proper provision for accruing annuity guarantee liabilities. As was the case

with most, but not all, offices, annuity guarantees were not provided for until 1998. As with the Companies Act accounts there should have been progressively increasing provision from 1993. The position of regulators and GAD on the Society's obligations in relation to reserving for the conversion rate in possession (which was the element of the annuity guarantee described as the GAR by the actuarial profession) was set out in a letter dated 7 December 1998 written by Roger Allen of HM Treasury to Nash. The regulators' position was that the Society had to make proper provision for all liabilities on prudent assumptions. He said:

> "In the majority of cases, Equitable Life's pension contracts appear to have been written so that the principal benefit provided is an annuity, and there is an option to take benefits in cash form. In the case of such a contract, the effect of Part IX of the ICR1994 is in our view to require full reserving for the liabilities to provide the annuity benefits to the value already guaranteed under the contract (i.e. to assume that 100% of policyholders take their benefits in annuity form), plus any additional liabilities arising from the cash option. ... we are not persuaded that any credit can properly be taken for any reduction in reserving requirements that would result from assuming policyholders would exercise their option to take their benefits in the form of cash. The guaranteed annuity appears to be effectively the benchmark for minimum liabilities, whatever "option" is chosen by the policyholder."

122. Allen rejected the Society's argument that the cost of the GAR could be met from terminal bonus, and therefore did not require to be reserved. He pointed out that the Society did not reserve for the terminal bonus itself. It could not look to a source of funding that was not included in the Society's mathematical reserves to cover a known liability. He contended that the company was effectively guaranteeing the terminal bonus up to the amount of the GAR.

123. The regulators intimated the official view that the accruing annuity guarantee liability ought to have been provided for in full, as reflecting the primary obligation under the retirement annuity form of contract and other annuity guarantee forms in use prior to 1988. When current annuity rates exceeded the GAR, the contractual option to take alternative benefits based on current annuity rates would have been required to be valued by reference to the excess. But there could be no reduction when current annuity rates were less than the GAR. The same view would properly have been formed at any point at which regulators or GAD had considered the issue over the material period: there was no relevant change in the regulatory requirements. While one can understand the short-cut involved in taking the higher current annuity rate for valuation purposes, allowing that approach to conceal the underlying contractual position was not appropriate. In the context of regulatory returns, the *Hyman* decision did not affect the gross valuation.

124. As discussed earlier, there were contract forms incorporating annuity guarantees in which the primary benefit was expressed as a cash fund converted at current annuity rates, with an option to take a guaranteed annuity as an alternative. Allen's description of the business was not accurate. But the critical issues were those related to the treatment of the retirement annuity type of contract where the description was accurate, and the differences among policy types were not material at that stage.

125. Substantial adjustments would have been required to the liabilities in and after 1996. The difference in value in 1993 was not large, and was considered to be transient. But even then disclosure of the value, however small, would have focused attention on the issue of principle, and would have done so at a stage when remedial measures could have been considered. To the extent that provision was not made for the Society's full annuity guarantee obligations, but was effectively restricted to the investment return and reversionary bonus elements in the computation, there were two deficiencies. In the first place there was selection of an interest rate that reduced liabilities from the level that would have applied under the Society's established approach. In the second place, with changing annuitant mortality experience, there

would have been an adjustment required to reflect the extent to which the mortality assumptions implicit in the conversion rate had become too weak properly to reflect experience. Failure to make appropriate provision contributed to the Society's apparent surplus, and accommodated over-allocation of bonus that would have been identified if appropriate liability values had been recognised. Policyholders and the interested public were therefore unaware of the extent of over-allocation involved.

126. As Allen had commented, terminal bonus was not included in the Society's mathematical reserves. There was no requirement to do so. To that extent the regulatory returns were less realistic than the office valuation. The position was not disclosed in the regulatory returns. Had future terminal bonus been provided for as a liability, or recognised as a factor restricting distributable surplus in some other way, it would not necessarily have been in the full amount accrued in the office valuation. Contingencies would have had to be taken into account, and inevitably the sum would have been lower, but in view of the narrow margins on which the Society survived, any material disclosure, such as could have been required to reflect policyholders' reasonable expectations, would have affected the Society's statutory solvency position. Claims were reflected at full value as in the office valuation. As in the case of the Companies Act accounts, there was the rather stark contrast between that treatment, that reflected the reality of the Society's practice on payment, and the failure to recognise the prospective payment of terminal bonus on in force business to any extent.

CHAPTER 7: FINANCIAL ADJUSTMENTS

1. In the context of the regulatory returns the Society made use of four technical adjustments in support of solvency that require closer scrutiny:

- future profits,
- quasi-zillmer adjustments,
- subordinated debt, and
- financial reinsurance.

2. Individually and cumulatively these supported the Society's solvency position at critical times, and their impact requires to be assessed. With the exception of the quasi-zillmer adjustment for which detailed figures were not disclosed annually, the position is summarised in table 7.1.

Table 7.1: Value of adjustments to Equitable's regulatory solvency position

Adjustments	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Future profits (FP):											
- authorised[1]	250	300	360	420	500	500	600	700	1,900	1,100	1,000
- used	-	-	-	-	250	264	313	371	850	925	1,000
Subordinated liabilities (SL)	-	-	-	-	-	-	-	346	346	346	346
Financial reinsurance (FR)		-	-	-	-	-	-	-	809	1,098	808
Regulatory cover ratio[2]	1.77x	1.67x	2.37x	3.75x	2.36x	2.90x	2.53x	2.51x	2.50x	3.47x	1.34x
Restated cover ratios:[3]											
Without FP	1.77x	1.67x	2.37x	3.75x	1.86x	2.45x	2.07x	2.07x	1.66x	2.63x	0.52x
Without SL	1.77x	1.67x	2.37x	3.75x	1.86x	2.45x	2.07x	1.66x	1.32x	2.33x	0.23x
Without FR	1.77x	1.67x	2.37x	3.75x	1.86x	2.45x	2.07x	1.66x	0.51x	1.34x	-0.4x

In 2000 the quasi-zillmer adjustment (see below) had a value of £0.9 billion. Adjusted for a value of that scale, the solvency position would have been adversely affected, and it appears likely that the same would have applied for recent previous years.

3. In the period from 1990 to 1993 the use of a high, but reducing, valuation interest rate supported solvency. The implicit future profits item began to make a contribution in 1994, when the second major change in the interest rate also applied. Future profits values increased relatively slowly until 1997, when the Society returned to its traditional practice in selecting a valuation interest rate in its bonus valuation at the same level as the gross bonus rate assumed, and an equivalent rate in the net premium valuation. There was then a step-change in the

[1] The sum originally requested for 1998 was £850m.

[2] The regulatory cover ratio represents the number of times the form 9 actual margin of solvency covers the required minimum margin.

[3] These ratios represent the accumulated effect of excluding the various regulatory levers used to support solvency.

value of the implicit future profits item from 1998. In 1997 the subordinated loan increased solvency, increasing the cover factor from 1.66x to 2.07 times (including the future profits item). When the annuity guarantee issue began to have an impact in 1998, financial reassurance rescued the Society from a position of near insolvency. As the table shows, without these adjustments the Society's regulatory solvency position would have deteriorated rapidly. In 2000 the Society would have been insolvent quite apart from the quasi-zillmer adjustment.

Future Profits

4. The inclusion of implicit items in the calculation of regulatory solvency was governed by article 18.3 of the first European life directive[4], which provided that there were three kind of implicit items that could be counted in the calculation of the solvency margin, subject to the provision of supporting evidence:

i. future profits;

ii. a zillmer adjustment in respect of acquisition costs where this was permissible in the underlying valuation, but had not been done as part of that valuation (of which more below); and

iii. hidden reserves (which consisted of any values resulting from an underestimation of assets or an overestimation of liabilities, other than mathematical reserves).

I am advised that, in practice, the third item was not used, that generally if zillmerisation was appropriate it was given effect in the primary valuation rather than as an implicit item, and that the first item only, future profits, was used with any regularity.

5. The regulations applicable from time to time under the Insurance Companies Acts during the 1980s and 1990s allowed offices to take credit for implicit items, subject to various conditions including an order under section 57 of the Insurance Companies Act 1974 or section 68 of the Insurance Companies Act 1982. There were no material differences between the provisions. Regulation 24 of the 1994 regulations prescribed one of two tests of the availability of credit of up to 50% of the full amount of future profits calculated in the prescribed manner. The regulation 24 calculation averaged the profits made in the long-term fund over the previous five years, excluding substantial exceptional items. One fifth of the aggregate was the 'estimated annual profit'. Multiplying the estimated annual profit by the average number of years to run on in-force policies, up to ten years, gave the full amount of future profits. So far the process was arithmetical. However, section 68 conferred a wide discretion, and the regulator required the appointed actuary of the applicant office to support the application by certificate.

6. As table 7.1 above shows, the Society first used part of the authorised amount in 1994. The certificate issued by Ranson on that occasion was typical of what was required. It stated:

> "I certify that the amount of £500m for which the Society is applying to be counted as a future profits implicit item does not exceed the lower of:
>
> (i) the amount calculated as at 31 December 1994 in accordance with Regulation 24 of the Insurance Companies Regulations 1994 applied on the basis set out in the Guidance Note on Applications for Orders to Count Implicit Items; and
>
> (ii) the present value of the profits that may be expected to arise in the future on the long term business in force on 31 December 1994."

[4] Council Directive 79/267/EEC of 5 March 1979.

The second part of the certificate was prospective and required the exercise of actuarial judgment. It was focused on the in-force business at the reference date, and looked to the profits that that business might be expected to generate in the future from the release of margins of prudence built into the valuation. It is implicit in the approach to this item that the adoption of a prudently low discount rate of interest in valuing liabilities would have generated a relatively high value for liabilities and understated distributable surplus. The second part of the certificate required the appointed actuary to say that the valuation in fact had that effect. As is discussed in the context of regulation, the Society regularly valued its liabilities on the weakest possible basis.

7. As with other actuarial techniques, taking credit for future profits can be understood in relation to traditional annual premium business conducted in a stable investment market. As Skerman described the net premium basis of valuation, it deliberately postponed the recognition of profit, even given stable returns, and might justify a review of anticipated profitability of the in-force business where the regulations bit too deeply. More particularly, as investment practice changed, the regulatory approach to equity yields, which excluded future growth, generated margins between the valuation assumptions and the reasonable expectations of investors as to the likely future performance of equity investment. Dealing with future profits as an implicit item subject to regulatory oversight imposed an obligation on offices to seek and obtain authorisation and that process could, in general, be expected to increase the protection afforded to policyholders. Regulators, with the assistance of GAD, could apply the regulations strictly in relation to the principal valuation, and then, on a discretionary basis, consider and form a view whether this form of credit should be allowed, off-setting the strict regulatory valuation to an appropriate extent.

8. In an office with predominantly recurrent single premium business, heavily invested in volatile equities, the regulation 24 computation has no obvious relevance to the realisation in the future of the margins inherent in the current valuation. The second factor certified was likely to be the more critical. Equating valuation margins and profits appears to me, not having actuarial qualifications, to be an inherently unreliable assumption. Realising revenue margins is seldom possible without cost. However, leaving aside my own prejudices, I am advised that it was widely recognised that an appropriate approach to this factor involved the construction of a model for the projection of a future revenue account that would reflect the valuation margins, levels of expenditure anticipated and contingencies. An alternative method involved re-computation of the mathematical reserves, but reducing or eliminating the prudent margins. A comparison of the respective values was a measure of the implicit profits that might be certified. Research of the records of the Society's appointed actuary by the inquiry's researchers and by its actuarial consultants has not disclosed records of either approach down to the end of 2000, the last relevant date.

9. Initially, the Society had been reluctant to use the future profits implicit item facility. Ranson anticipated that competitors would see the use of such an item on form 9 of the regulatory return as a weakness and that it would result in possible adverse comment. At a meeting on 14 November 1990 he asked GAD what their stance on the granting of such orders was and was informed that GAD considered that the means were there to be used. The regulatory policy was clear. It was for the Society to decide whether to proceed with an application. The Society had suffered a bad year (a negative return of 10.4% equating to a loss of capital of £790m) and its RMM had dropped considerably from 4.77x in 1989 to 1.77x in 1990. As mentioned above, the Society weakened its valuation basis and by that means generated a surplus of £560m on the regulatory approach. The valuation was not questioned because it fell within the limits of the regulations according to GAD. It was appreciated at the time that the Society had over-distributed, and was weak. Equitable was not discouraged from making use of the implicit future profits mechanism in these circumstances.

10. The Society's reluctance to use the facility was typical of the industry. When the directive was implemented the then Government Actuary encouraged use of the future profits item, but actual use was very unusual throughout the 1980s. Especially after 1988, when independent financial advisers were required to give best advice, balance sheet strength became a significant factor, and it was thought that use of the future profits item reflected weakness.

11. The Society's first application was made on 20 December 1990 for an implicit profits item of £250m[5]. The supporting calculations showed that the Society had calculated its annual average profit over the years 1985 to 1989 at £140m. An average period to run of 8 years had been assumed. The total estimate of future profit gave a total estimated future profit of £1.1 billion on these basic figures. In accordance with the guidance, the maximum amount of the implicit item relating to future profits was 50% of the product of the estimated annual profit and of the average period to run on the policies in the company's portfolio. That would have allowed an item of £560m. The sum requested by the Society, £250m, was 44% of that sum. The order was forwarded to the Society on 11 January 1991. The pattern thereafter was similar. The arithmetical calculation brought out total estimated future profits in excess of the sum sought, and of the sum approved part only was appropriated for use.

12. As the 1990s progressed, and especially in and after 1998, the amounts used increased in cash value and as a proportion of the total amount available and authorised. The orders were granted routinely if the supporting calculations were correct. In correspondence with the Society GAD on occasion challenged the computational aspects of the supporting material. The second aspect of the appointed actuary's certificate appeared to excite little interest until the end of the reference period. Future profits implicit items were there to be used: the regulations provided for them. Checking the arithmetic and granting approval would have been seen as routine, eliciting no concern on the part of regulators and their advisers. The guidance note of October 1984 set out the rules by which firms could apply for this facility and subject to these being followed, the application was a formality. So far as the inquiry's researches have shown, the second aspect of the certificate was not supported by the kind of extensive or penetrating analysis and projections of future trends that might have been expected. The procedural rules set out in the guidance were followed by the Society. The Society's applications to use future profit made use of recognised means to enhance its solvency position. However, there was no indication that there was a serious assessment of the Society's overall financial health in the context of making use of this adjustment by the Society's actuaries.

13. At the beginning of the 1990s, the distribution of the Society's premium income reflected a greater volume of single premium business and a reduction in annual premium business. This became significant in the discounting applied in the liability valuation basis mentioned above, which resulted in early profit recognition. In addition to producing increased current surplus, the Society had the benefit of an increased base level from which to calculate total future profits. The cumulative effect was to accelerate the emergence of surplus, and inflate the future profits item. Accordingly, in my view, there was an increased requirement for the Society to make a critical assessment of the future profits addressed in the second part of the appointed actuary's certificate. In the event, the Society's stated average annual profit figures were increasing year upon year. With increased levels of stated average annual profits, when the Society began utilising the item to support the minimum solvency requirement the practice was never questioned.

14. As is shown in table 7.1, after the relatively strong position in 1993, once the Society started including the implicit item in the form 9 statement of its solvency position, RMM cover never rose above a factor of 3x. More importantly, when the implicit item was removed from the RMM, the cover factor was substantially lower. As the 1990s progressed, and market volatility became more pronounced as one now

[5] See chapter 16, paragraph 30.

knows, the validity of the arithmetical stage in the computation became more questionable, in my view. Past investment performance became less relevant as a measure of the future profitability of the in-force business. There was a corresponding increased need to verify the future availability of profits on the in-force book. The inquiry has not found evidence that this was done.

15. As a matter of arithmetic, starting from 1994 the Society initially used the implicit item to equate the value of assets as between the Companies Act accounts and the regulatory returns. The presentation suggested that the application of the item reversed the rejection for regulatory purposes of inadmissible assets. However, the fundamental effect was to bolster regulatory solvency, whatever the presentation, with insubstantial proof that the future profits would in fact be likely to emerge from the existing book.

16. From 1998 onwards when the Society's annuity guarantee problem began to bite, a greater proportion of the approved implicit item was taken into account in the form 9 position. As the overall financial position became precarious, the Society began making near full use of the item in the returns. Had it not done so, it would have come dangerously close to technically insolvency.

17. The effect that the future profits implicit item can have in disguising the true solvency position of life businesses has been recognised. It is proposed that it should be phased out after a transitional period. As noted already, one can perhaps understand the use of the item in relation to conventional annual premium business valued on the net premium basis. The valuation basis is not realistically related to actual contractual premiums. Leaving future surplus to emerge, as envisaged by Skerman, over the duration of the contract is fundamentally prudent, helps realise policyholders' reasonable expectations of future bonus, but is stringent. It precludes credit for future profit that the office realistically expects to earn from the ordinary working out of the contract. However, even if recognition of implicit future profits were to remain part of the regulatory system in the future there would have to be an assessment of its suitability for use with recurrent single premium business. In the case of Equitable, the item assisted in the support of regulatory solvency in a situation in which the Society's weakness generally was only known internally from the office valuation.

Quasi-Zillmer Adjustment

18. Zillmerisation may be used in the principal (net premium based) valuation or as an implicit item. Equitable never made application at any stage for approval of an implicit item, and that alternative can be ignored. In the case of the principal valuation the adjustment was provided for in regulation 58 of the 1981 regulations and regulation 68 of the 1994 regulations, which were in identical terms. The adjustment recognised that where future premiums were being valued in terms of regulation 67 (57 of the earlier regulations), the maximum annual premium to be valued would not take account of the reality that the life office would have priced the product on the basis that un-recouped initial or acquisition expenses would be recovered from future premiums. It permitted an adjustment, subject to defined limits, to increase the permissible future premium by annuitising the un-recouped excess over a period not exceeding ten years. The mathematics are not material for present purposes.

19. The conditions regulating the use of zillmerisation are material. Regulation 68 is ancillary to regulation 67. It applies expressly and exclusively where the actuary is valuing the maximum annual premium in terms of the earlier regulation. Regulation 67 applies:

> "Where further specified premiums are payable by the policy holder under a contract..."

The provision distinguished annual level premium contracts and variable premium contracts. In relation to the latter, it provided:

> "... where the premiums under the contract are not at a uniform rate throughout the period for which they are payable, the premiums to be valued shall be not greater than such premiums as would be determined on the principles (applicable to level annual premiums) modified as appropriate to take account of the variations in the premiums payable by the policy holder in each year.
>
> Save that a premium to be valued shall in no year be greater than the amount of the premium payable by the policy holder."

20. On the terms of the regulations, there was no proper basis on which the actuary could have proceeded to zillmerise recurrent single premium business whatever methodology was available, in my opinion. The Society's recurrent single premium contracts gave the policyholder the option to make further contributions, subject to any relevant Revenue restrictions. But, with the exception of some contracts in which there was a small minimum contribution required to keep options alive, there were no future premiums, level annual or variable, 'payable ... under a contract'. The fundamental condition for zillmerisation was not met to any material degree.

21. The year in which the Society first made use of a quasi-zillmer adjustment in the form that ultimately became controversial is not known. It appears to have been incorporated into the principal valuation, but not explicitly described, at the latest in 1991. Headdon indicated that it commenced in the early 1990s. It was subsequently used in the Society's resilience calculations for regulatory purposes. It appears likely that it was used before the implicit future profits item was actually employed. It was clearly used in the resilience computation in and after 1994.

22. The first relevant documentary evidence the inquiry has identified from the regulatory files comes from an exchange in November 1991. Paul Burt, principal actuary[6] at GAD with responsibility for the Society, had raised a query in relation to the 1990 returns, lodged in the summer of 1991, concerning the treatment of expenses contingencies. In his reply of 22 November, Ranson explained that there had previously been an estimated shortfall of future premium loadings to meet future expenses. With the move to recurrent single premium business, he said that there was now sufficient provision in the total reserves for future expenses. On 12 May 1992, Ranson wrote again. He commented that initial expenses would be recouped as business matured because there was "no accepted method of 'zillmerising' recurrent single premium business, which is about 80% of our business in force". An internal GAD note of 14 May 1992 took up the point and proposed that it should be queried.

23. Ranson referred to zillmerisation as a possible route by which to weaken the Society's reserving basis in a letter to Burt dated 17 September 1992. Burt wrote again at the end of October, following the detailed scrutiny report for 1991, asking about the amount of the valuation strain in respect of the additional business written in 1991. Ranson replied on 6 November. He included among other things in his letter a computation of policy values as against asset values, and in relation to the business strain point he said:

> "... we have compiled an analysis of the financial impact of the 1991 new business... The results of that analysis show that new business did not produce a strain during 1991. This was due mainly to the fact that the valuation bases for recurrent single premium business released monies at the outset in a similar way to the release produced by a zillmer adjustment."

From this it could have been inferred that Ranson had found a mechanism similar to a zillmer adjustment to reduce valuation strain. However, the zillmer point was

[6] See chapter 15, paragraphs 39 to 44, for note on the terms used to refer to regulatory officials.

not pursued in subsequent correspondence by GAD. Burt left GAD shortly after, and no further queries on this topic were raised when the scrutinising actuary, who was new, wrote to DTI and to Ranson on 3 March 1993.

Disclosure of the Quasi-Zillmer Adjustment

24. Thereafter, the Society never clearly communicated the nature of its quasi-zillmer adjustment to GAD. References were included in the regulatory returns for 1994 onwards, but not in clear terms that would have alerted the scrutinising actuary. Disclosure in the 1996 returns was in different terms from the earlier disclosures in 1994 and 1995, but the change of language does not appear to have reflected any change of substance. The only way to have identified the adjustment at that stage would have been to have examined in detail the Society's resilience calculations. Even where a resilience reserve was not disclosed it was necessary for life offices to carry out the necessary calculations, and scrutiny of these would have disclosed the nature and value of the adjustment, but at that stage Equitable did not make provision for a resilience reserve. Equitable made an adjustment of ½% of with-profits fund values which significantly reduced resilience reserving requirements, eventually to the extent of £0.9 billion as indicated above.

25. GAD did not become aware of the ½% quasi-zillmer adjustment of the with-profits fund values for future expenses recovery until to the department became involved in discussions with potential bidders in the course of the sale process. It had become a source of concern to potential buyers who had been alerted to it by a report dated in 2000, prepared by Ernst & Young for the purposes of the sale of the Society. GAD and regulators were in close contact with a number of potential bidders at the time. Equitable had not provided a copy of the Ernst & Young report to regulators or GAD before these discussions began.

26. When the change of methodology had happened, from making the adjustment in the liability valuation to making it in the resilience computation, and how the sum of £0.9 billion built up, I cannot say. But it was clearly an important prop to regulatory solvency of increasing value over the 1990s. One would expect a relationship between the value of the item and the growth in fund value. That would indicate a concentration in the growth of the item in the second half of the 1990s. But a more particular analysis would have required disproportionate investigation. It was not a legitimate device, in my opinion, on the terms of the regulations, and it supported solvency without regulatory justification. By the end of the period it had become a major contributor to the apparent solvency of the Society.

27. In a letter dated 16 November 2000 (still before GAD had sight of the Ernst & Young report, but after the point had been raised with them), Headdon explained to Hewitson, the directing actuary, his view of the justification and genesis of the deduction:

> "As I mentioned when we met, the Society's recurrent single premium contract is somewhat unusual... and has never fitted the valuation regulations, which have been essentially based on a net premium valuation of level premium contracts, particularly well. As such, over the years, a certain amount of interpretation has been needed to determine minimum reserving requirements, particularly in resilience test conditions.
>
> In particular we have included an allowance for unrecouped acquisition costs consistent with the spirit of regulation 68, which necessarily takes the form of a reduction in benefits. It has been my understanding that that was something discussed with GAD when my predecessor, R H Ranson, introduced the practice in the early 1990s. From the files I have inherited I cannot find specific correspondence on the topic but note that meetings were held in September 1992 and November 1993 when detailed discussion of the approach to resilience testing was a major item on the agendas. From the 1996 Returns onwards, following new regulations requiring greater disclosure of the approach to resilience testing, the approach has been described in

> Schedule 4 each year... For clarity I should confirm that the approach is only taken on contracts where future premiums are payable. True single premium products such as bonds and income drawdown products are excluded.
>
> Because the approach is non-standard some of the prospective purchasers would like to see some more explicit confirmation that GAD feels the approach is reasonable."

Headdon's explanation was less than specific as to the start date of the practice. The documents available to the inquiry do not reveal any support for the suggestion that the Society's approach to the resilience reserve had been made explicit during the 1992 and 1993 meetings. As noted already, the adjustment appeared first in the 1994 returns. But it showed that the ½% related to a quasi-zillmer adjustment in the resilience computation. The restriction of the practice to contracts on which 'future premiums are payable' should have provoked a response: the policyholder had a right to pay further premiums, but the Society had no right to demand them. As noted in earlier discussions, the justification for zillmer adjustment depended on a future income flow based on contract. That could not be relied on where future premiums income was wholly within the control of the policyholder.

28. One of the GAD actuaries replied on 23 November 2000 suggesting that the way the matter had been phrased in the returns had been confusing. He commented about the phrase used:

> "At first sight this seems to be an additional allowance for renewal expenses, but it now appears to be a Zillmer adjustment in respect of unrecouped acquisition costs."

29. John Rathbone, who succeeded Burt as the principal actuary at GAD with responsibility for the Society, recalled in evidence to the inquiry that:

> "... With Profits Without Mystery mentions the use of a Zillmer adjustment... this issue was brought to GAD by Ranson in the late 1980s or early 1990s after he wrote the paper but I believe that GAD said that we did not understand how you could take credit for this and dismissed it as inappropriate. We were not aware that Equitable was using a quasi Zillmer adjustment in 1993. Later after the Ernst & Young discovery we challenged their treatment and Headdon suggested that GAD had previously agreed it, so I looked back in the file. If it was this ½% adjustment, it was definitely thrown out."

No documentary evidence has been recovered to support the statement that GAD had formed or communicated a view on the quasi-zillmer adjustment and had 'thrown it out'.

30. As I have noted already, the information exchanged about the practice was more complex. At a meeting between GAD, DTI and the Society on 9 December 1994 the minutes recorded as the final paragraph:

> "Valuation – they always went for the weakest possible valuation. GAD noted that recurrent single premiums were very similar to the net premium valuation method. Mr Ranson said they took **no** account that 90% of the recurrent single premiums would be renewed."

GAD could have concluded from the statement that no account was taken of renewal of recurrent single premiums that it had not been claimed that a zillmer adjustment was appropriate in the liability valuation, and therefore that there could not be a zillmer item in the resilience test. However, it is not clear that the position was rationalised in this way.

31. In relation to the quotation from the 1994 minute, Rathbone told the inquiry:

> "With hindsight you might see Roy Ranson's presentation of the returns as devious and hiding what he was really doing."

He went on to say in respect of the phrase used in the 1996 returns:

> "This was assumed to relate to a provision for ongoing expenses but that was not what Headdon admitted to at the end of the day."

He continued:

> "By 2000 he [Headdon] implied that he had taken account of recurrent single premium in that they took credit in the valuation of a fund charge of ½% per annum by deduction from asset shares. This is detailed in their response... [to the 1993] bonus questionnaire. This is a similar methodology as not providing for GARs because the terminal bonus would cover it. This reply is about their asset share policy and says nothing about their reserving basis, but it is apparently what they ended up doing for the resilience scenario. It is also what they described as a "Zillmer adjustment" in the returns following the questions we asked in 2000. They were taking credit for ½% additional income rather than for Zillmerisation... Headdon admitted that they were taking credit for ½% extra yield and Ernst & Young had raised the issue in an actuarial report... We could not see this as an appropriate adjustment... This "Zillmerisation" issue had been raised in previous correspondence. GAD had rejected their proposals and they still adopted them because they were so sure that no one had the right to challenge them."

It is apparent that the Society's position was confusing and was confused in the mind of regulators.

32. I have already referred to correspondence down to November 1992, and the explanation given by Ranson that the main reason why new business had not produced a strain in 1991 was that the valuation bases for recurrent single premium business "released monies at the outset in a similar way to the release produced by a zillmer adjustment". There was a clear inference to be drawn that the Society was using the equivalent of a zillmer adjustment in the valuation bases in 1991. While it is possible that Burt's successors could have taken a different view of the appropriateness of the quasi-zillmer adjustment, that appears unlikely, and the lack of any relevant comment indicates rather that the point was lost sight of at that time and did not emerge again until much later.

33. The disclosure in the 1996 returns has been generously described by Hewitson (who became responsible as directing actuary for the team supervising Equitable in October 1997, having previously been involved as a principal actuary in the policy area) in his evidence to the inquiry as "cryptic". One could say no less about the 1994 and 1995 returns. Given the confused state of the information provided, it was perhaps understandable that GAD failed immediately to detect the true meaning of the disclosures.

34. However, it is less understandable that the obscurity did not provoke detailed and relevant questioning of the Society. One consequence of this state of affairs was to be that when GAD and the DTI were considering the likelihood of the Society being sold successfully, they did not know (until the very last minute) of the existence of this deduction and the significant effect it had upon the financial position of the Society. It seems plain from the documents available that GAD (and therefore DTI and Treasury) were unaware before receiving information about the content of the Ernst & Young report in 2000 that the Society had operated, since the early 1990s according to Headdon, the quasi-zillmer adjustment in respect of unrecouped acquisition costs.

<u>The Subordinated Loan</u>

35. In the context of long-term business, the conditions for approval of the issue of hybrid capital, including perpetual subordinated loan forms, were set out in a prudential guidance note, PGN 1994/1, 'Hybrid Capital: Admissibility for Solvency',

following the provisions of the third life directive[7]. The principal requirement for approval was that the instruments should have the effect that in the event of the winding up of the insurer the capital and interest accrued but remaining outstanding must be subordinate to the claims of all other creditors. In the case of with-profits funds, the guidance added two conditions: (a) the debt should not constitute a liability attributable to the long-term fund, and the rights of the creditors should be met from assets held outside of that fund; and (b) the subordination should extend to liabilities assessed in respect of all long-term business policies including the value of bonuses to meet policyholders' reasonable expectations. Where the conditions were met, the subordinated debt was available (subject to prescribed limits) to contribute to solvency cover.

36. As a matter of mechanics, the guidance provided that the regulator had power, by waiver or modification of the rules by order under section 68 of the 1982 Act, to allow insurers to count the value of relevant hybrid capital instruments towards a proportion of their required margin of solvency. The guidance described the type of instruments that would be eligible, the procedure to be followed, the admissibility limits that would apply, and the terms which such instruments should provide, in order to qualify. These terms were not to be regarded as definitive. There was a wide discretion.

37. The guidance described hybrid capital as essentially loan capital, but unlike an ordinary loan, the instrument contained conditions which, *inter alia,* removed some of the lender's usual rights. These conditions allowed the loan to be treated like the proceeds from the issue of shares for regulatory purposes. The 3rd life and 3rd non-life directives each allowed the value of four types of hybrid capital to count as cover for the required margin of solvency. For present purposes the relevant type was perpetual subordinated loan capital. In the case of mutuals there was provision for subordinated members' accounts, the form that initially interested Ranson. The regulators' main concern was that insurers should have sufficient risk capital to meet unexpected pressures on the insurance business, and it was stated that applications to count loan capital as part of insurers' solvency margin would be viewed in this light.

38. Applicants were advised that the section 68 direction would probably vary the terms of the determination of liabilities rules (specifically rule 5.2) to provide that the liability to repay the value of the loan capital might be excluded. This exclusion would be limited to a value determined by calculating a proportion of the required margin of solvency. Certain terms were prescribed. The instruments at a minimum had to be compatible with the provisions of article 16(1) of the 1st non-life directive or article 18(1) of the 1st life directive as appropriate. Indent 7 of article 16(1) specified the minimum conditions for subordinated loan capital; indent 8 defined the basic terms for the perpetual security. All insurers could issue the latter two forms of hybrid capital. The terms of article 18(1) were identical in this respect. In other cases, the instruments had to have the effect that in the event of the winding up of the insurer the capital and interest accrued but not paid (including any deferred interest) must be subordinate to the claims of all other creditors. The note holders would rank after all other creditors but before the members in any distribution. In the case of a mutual, the note holders would rank after members in their capacity as policyholders.

39. Further it was provided that the subordination provisions should also take into account the need to protect the position of with-profits policyholders of long-term insurers. With-profits funds would include sums being accrued to meet future bonuses to policyholders. Such funds were customarily held in the long-term insurance fund on which, upon liquidation, other creditors and also shareholders might have a claim.

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[7] Council Directive 92/96/EEC.

40. The regulator requested that the relevant documentation satisfied the following two requirements. The first was that the loan (capital and interest) should not constitute a liability attributable to the long-term insurance fund of an insurer. The rights of the note holder should be met from assets held outside the long-term insurance fund. This was to ensure that, as the insurer was trading, the position of the with-profits policyholder was fully protected. Second, the documentation should have the effect that the rights of the lender were subordinated to all other creditors of the insurer in the event of a winding up. It was provided that this should, in particular, secure that the note holder's claims on the assets of the insurer were to be subordinated to the liabilities assessed in respect of all long-term insurance business policies, including any amounts payable to reflect the value of bonuses to meet the reasonable expectations of with-profit policyholders. Responsibility for achieving effective subordination lay with the insurer. Applicants were recommended to seek legal advice from those with relevant expertise in this field since the effectiveness of the subordination provisions would depend on an accurate understanding of the relevant law.

41. In addition to notice requirements allowing the regulator to prevent early repayment should this imperil the solvency of the insurer, it was said that directions under section 68 would probably require the non-payment of interest and capital if payment, or any other event, would result in breach of the required margin of solvency. There were provisions requiring deferment of winding-up applications to provide a breathing space in the event of default.

42. Maturity and early repayment conditions were to be controlled. Perpetual subordinated debt containing provisions triggering the determination of a date for repayment might be acceptable, but the regulator would probably require at least five years' notice. Where such notice was to be given the regulator would also require to be informed. It was said that perpetual securities should not be repaid other than at the behest of the issuer and the regulator would require to be notified.

43. Where early repayment of hybrid capital was in prospect, the insurer was required to write to DTI with an explanation showing how the required margin of solvency was to be maintained. Insurers were advised that they should not make agreements which provided for early repayment triggered by performance conditions, cross-default clauses, negative pledges, or other restrictive conditions. There were provisions for transfers and mergers. The note commented that it was common when an insurer got into severe financial difficulties to try and arrange a transfer of portfolio to, or a takeover by, another insurer to safeguard the position of policyholders. Insurers were informed that they should not agree to any restriction which would inhibit or prevent this. There were provisions regulating foreign currency instruments. Insurers should be able to demonstrate to the regulator how the foreign currency debt would be serviced, or alternatively what hedging arrangements existed to reduce the currency risk. Where capital was raised for foreign operations, the regulator would expect sufficient income to be generated in the relevant foreign currency to service the commitments under the loan capital agreement.

44. There were complex provisions about interest. The interest basis was to be clearly stated in the agreement. In the case of subordinated loan capital, where payment of interest or capital was suspended, the agreement might provide for the unpaid interest to accumulate. But the agreement should not permit further penal interest charges to attach as a result of the suspension. Loan capital instruments with a fixed or stepped rate and those with a floating rate were acceptable as cover for the required margin of solvency. Floating rates were to be expressed in terms of a reference point such as the rates from time to time prevailing in the inter-bank market or rates applicable to government securities. There were supplementary constraints.

45. Finally there were requirements relating to disclosure. The documentation relating to the issue had to explain the key features of the instruments so that small

or retail investors in particular were aware of the nature of their investment and the risks associated with the purchase. It was said that the listing requirements of the stock exchange might be sufficient to meet the point, as might compliance with disclosure rules under the Act. Where the stock was not quoted and the Act did not apply, the regulator was to be consulted about disclosure to potential purchasers if the issue was priced to enable small investors to participate.

46. These requirements were complex, expensive to set up, and, in my view would only have been appropriate to transactions of major significance to an office such as Equitable, and, one would have thought, they were not such as to be undertaken lightly or without having in mind a material need for capital that could not readily be obtained in other ways. In the case of a mutual with unlimited liability such a transaction was important not only internally, but also in relation to the members as individuals. The Board first considered subordinated loan capital in 1993. At that stage, the Board's interest was in the possibility of raising capital from policyholders on an ongoing basis, such as by issuing five and ten year subordinated redeemable bonds to members, rather than through the market. At that stage it was seen as a way of providing policyholders with an additional vehicle for investing with the Society on favourable interest terms.

47. Ranson had already approached DTI seeking comfort in principle for the issue of up to £100m capital value of redeemable individual bonds. The correspondence which followed will be considered in greater depth in chapter 16. For present purposes it is sufficient to note that Ranson said that, while the Society was not short of capital, the bonds could release 'new business strains' and 'strengthen' the form 9 position (he characterised this strengthening to GAD as a "by-product" of offering an attractive new option for policyholders). Ranson thought DTI's draft prudential note (subsequently 1994/1) covered the possibility.

48. The proposal for redeemable bonds was not in the end pursued in 1993-94, but the Society returned to the issue of subordinated loans in 1996. The subject was raised with the Board on 27 March 1996. By July, NPI's successful issue had been reported in the press, and Ranson reported on it to the Board in his managing director's report that month. Ranson said that he was 'keeping in touch'. He reported more fully in October and explained that he was in contact with various providers, and explained how subordinated loan capital improved regulatory solvency.

49. There were further developments in November 1996. Ranson mentioned the possibility of an application for a section 68 order for a subordinated loan at a meeting with regulators on 8 November. In his November report to the Board, he explained that part of the explanation of Standard & Poor's relaxed approach to the Society was that they were confident that it could raise capital if it became either desirable or necessary as referred to in their press release.

50. The theme continued in January 1997. At that meeting of the Board, he reported that the Society's 'form 9' position was becoming tight and that this could cause restrictions on investment freedom. The point was made that if the equity market should drop significantly it could cause technical solvency restrictions which would prevent the Society investing in equities when it would otherwise wish to do so in the interests of its policyholders. As appointed actuary, Ranson recommended that the Society should take such a loan when it was in a strong position, as he said it was at that time, rather than when it might be forced to do so. The Board approved in principle.

51. It is not made clear in the documents why Ranson relied on his role as appointed actuary in offering advice on the timing of the transaction, which seems a matter of general financial management. It would have been understandable if he had advised on the need for subordinated debts specifically to support solvency in that role. It is possible that Ranson may have used his role as appointed actuary simply to add weight to general financial advice, especially when members of the board may have been reluctant. But the wider context suggests that solvency was

the primary driver, and that reliance on his position as appointed actuary was appropriate.

52. At the board meeting on 26 February 1997, Ranson reported on the Society's position of strength, as recognised by Standard & Poor's, and that a subordinated loan would enhance the free asset position. In March Ranson informed DTI of his intention to apply for an order for £300m of subordinated debt. To the Department he said that the loan was 'essentially for investment purposes, not to finance developments". He asked whether the Society could avoid setting up a subsidiary for the purpose in accordance with what had by then emerged as the common practice in such issues.

53. Within the Society, discussion continued in April and May. There were concerns about currency risks. There were concerns about costs. Some directors had concerns about future risks more generally. The Board resolved that implementation of the raising of the loan by the two current potential providers should be halted pending review, even in the face of advice that there was a case for some speed in case investment markets moved in a way that caused solvency to come under pressure. Notwithstanding other suggestions it was clear by this stage that the substantial reason for seeking this form of capital was to engineer the Society's regulatory solvency position.

54. Meanwhile, on 1 May DTI had placed the onus for ensuring that the terms of the guidance were met back on the Society and its legal advisers. At the Board meeting on 25 June, it was agreed that any effects of the forthcoming Budget would be monitored, and subject to that, the Board agreed to proceed.

55. Following further exchanges with the regulators[8], it was agreed on 3 July that the loan would be in sterling, and a subsidiary would be used in accordance with industry practice. On 10 July Dentons wrote to DTI with details of the draft documents, which had been based on the NPI issue. In the letter, they stated:

> "In addition, as Equitable Life is incorporated ... as an unlimited company, an additional technical paragraph has been added to Condition 3 (Subordinated Guarantee) on page 6 of the draft Offering Circular, intended to ensure that members do not incur any liability in the event of a failure by Equitable Life to meet its obligations under the Guarantee."

A form of clause was appended. DTI proposed a further amendment to ensure effective subordination, which was rejected, and DTI indicated on 18 July that they were willing to issue the requisite order. On 23 July 1997, it was minuted that the subordinated debt issue of £350m had been launched on 18 July, and that the proposal was for notes or bonds to be issued on the Eurobond market and possibly a sale in the United States pursuant to rule 144A under the UK Securities Act of 1933. Powers were delegated to named directors to approve and provide for the execution of the necessary documents, and in particular to take steps to ensure listing of the bonds on the London Stock Exchange and/or any other exchange as considered appropriate.

56. Thereafter, the Board was convened on 4 August 1997 to provide further powers and instructions. It was resolved that it was in the interests of the Society that it should guarantee the bonds to be issued by the subsidiary in the aggregate principal amount of £350 million, and ancillary powers were delegated. Further steps to ensure listing were put in hand. The Society was in a position to proceed.

57. The draft loan agreement between the Society and its subsidiary reflected the provisions for subordination of the loan, and those designed to protect policyholders as already envisaged. A press release sent by Equitable to DTI and other "interested parties" (but not issued more generally) on 18 July set out the Society's position:

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[8] See chapter 16, paragraphs 207 to 221 for discussion of these events from a regulatory viewpoint.

> "The Equitable Life Assurance society has issued a £350 million perpetual bond through the sterling eurobond market. The capital is being raised through a fully owned subsidiary Equitable Life Finance PLC, which is guaranteed by the society, and the proceeds of the issue will be used to provide gearing in the with profits fund."

58. The section 68 order was issued on 19 August 1997. The financial media's response was that the issue was a prelude to de-mutualisation. One analyst said that he was advising people to 'carpetbag'. He commented that the loan would not be sufficient to change the balance sheet, and that the Society would follow other mutuals. As a practical matter, the loan issue was successful, but the proceeds were immediately absorbed in offsetting the result of the changes in taxation of dividends. On 24 September 1997, Headdon reported to the Board that calculations of the Society's solvency position had confirmed the conclusion reported earlier that the combined effects of the change to the tax treatment of dividends and the issue of the subordinated debt were such as to leave the free assets at the level which would have applied had neither event taken place.

59. As would have been clear from the guidance, this had been an enormously complex transaction to develop and put in place. By the end of 1997, the fund was over £23.5 billion. Premium income for the year was £3.5 billion and investment income was over £1.3 billion. In 1997, as previously indicated, the society celebrated a year of success in its published accounts. The transaction was designed to contribute £350m of capital. The investment potential of such an injection of capital was low relative to the cash flows generated by the Society's ordinary business. In my view, the only substantial explanation for it was that it augmented distributable surplus, and that it was put in place in anticipation of the need to use it as the Society's financial position deteriorated, and was expected to deteriorate.

60. The Society continued to take advantage of the pre-existing order throughout the remainder of the reference period and disregarded the liability accordingly in its form 9 balance sheet. In the Society's statutory accounts for 2002, the position of the debt was described in these terms:

> "The payment of principal and interest in respect of the Bonds has been irrevocably and unconditionally guaranteed by the Society. The obligations of the Society under the guarantee constitute direct and unsecured obligations of the Society. In the event of a winding up of the Society, the claims of the bondholders under the guarantee will be subordinated in right of payment to the claims of all creditors of the Society.
>
> In accordance with the Trust Deed, where the payment of any amount in relation to the Bonds is due and the Society cannot meet the Required Minimum Margin ... of assets over liabilities required under the Trust Deed, by reference to the Insurance companies Act, 1982, on the due date (or would not be able to meet RMM immediately after such payment), then the payment (or an appropriate part thereof) will be deferred unless the FSA's consent is obtained."

61. It appears that the Society understands that apart from regulatory purposes the debt is a current liability, subject to the priority of policyholders' interests in the liquidation of the Society or when payment of sums due would reduce the Society's position below RMM. The bondholders have no incentive to seek a winding up since they would in that event lose their normal priority. At the inquiry's reference date, the debt remained available to support regulatory solvency. The cost of servicing it had increased as market interest rates fell. Dependence on it for solvency purposes was an indicator of the Society's continuing weakness at 31 August 2001, notwithstanding the cut in policy values.

62. One aspect of the transaction that caused me some concern was the potential personal liability of members of the Society for the debt in the event of insolvency of the Society. The issue of members' personal liabilities arises from the constituent

documents of the Society and general law. It arose in the course of preparations for the House of Lords in *Hyman*. Elizabeth Gloster QC explored the issue on 5 February 2001 in developing a line of argument:

> "EG explained that she had given further consideration to the status of the Society's members. Although a mutual the Society is in a slightly unusual situation because it is incorporated, albeit on an unlimited liability basis. ... the company owners (i.e. members) are beneficially entitled to the assets. Equally there are liable in the event of insolvency. ...
>
> There was discussion as to paragraph 4 of the Society's articles of association. This provides that:
>
>> "Every policy shall be granted by the Society on the terms that the Society shall only be liable thereunder to the extent of its assets and property from time to time existing, and that no Member of the Society, and no other person who is at any time in any way interested in any policy, shall be liable to any call or contribution, whether in a liquidation of the Society or otherwise howsoever for satisfying any claim or demand under or in respect of the policy so granted, whether by the grantee thereof or by any other person for the time interested therein".
>
> On a strict analysis obviously each member is liable for the Society's debts with rights of contribution as against each other. EG said that this limitation of liability does not and could not affect the liability of members in a disaster scenario whereby liability has wiped out all the Society's assets. ... The answer must be that each of the Society's policyholders are liable for all the Society's debts with rights of contribution against each other. ..."

It appears to me that that analysis was correct.

63. As mentioned already, the Society took steps to protect individual members from liability. Recovery was said to be restricted to the available assets of the Society, and there was the express provision quoted above that sought to address the issue directly. The Society, and latterly the FSA, have been advised that the steps to protect members are effective. This inquiry is not an appropriate form of procedure to resolve any issue that might yet arise. In this respect as in others the resolution of disputes is a matter for the courts. But I should note that I have been approached by representatives of the bondholders who have informed me of their interest. The bondholders approach to me reflects their belief that any funds that might be recovered by the Society as damages or compensation for losses arising from the conduct of the affairs of the Society should be available to meet the Society's obligations to them as well as obligations to policyholders. To the extent that the Society may cut back on declared reversionary bonuses and may allocate surplus as terminal bonus, the bondholders may assert priority over policyholders. The problems associated with valuing policyholders' reasonable expectations generally are discussed later. But, given the attitude of the bondholders as intimated to me, the subordinated loan could represent a potential cost that could impact on the policyholders' realistic expectations of improvement in their financial position.

64. In the immediate context of regulatory solvency, the debt was treated as subordinated in the calculations for 1997 and later years. That was a material factor in presenting the Society's regulatory position. In the Society's office valuation the subordinated debt was treated as a contra item. The effect was therefore to improve solvency relative to the realistic presentation of the Society's financial position. Having regard to the terms of the guidance, there is no formal objection one could make to the treatment of the debt in the ways mentioned. But it appears to me that there is considerable difficulty in justifying the transaction on a broader basis. The source of payment of interest and of repayment of the capital borrowed had to be future investment returns. As such, the subordinated debt added to the demands created by the use of the future profits implicit item, zillmerisation and

later by reinsurance to accelerate the benefit of future profits and reduce the resilience of the Society to accommodate the impact of future adverse events.

Financial Reinsurance

65. Reinsurance, generally, is well understood. It was defined in the 1998 SORP[9], as:

> "An arrangement whereby one party (the reinsurer), in consideration for a premium, agrees to indemnify another party (the cedent) against part or all of the liability assumed by the cedent under the policy or policies of insurance."

Reinsurance outwards is defined as:

> "The placing of risks under a contact of reinsurance."

Fundamental to the definitions was indemnity, and the passing or sharing of risk.

66. In November 2003, a revised SORP was issued which contained a definition for 'financial reinsurance' in addition to the previously definition of reinsurance. The 2003 SORP defined financial reinsurance, as:

> "Where a reinsurance contract is intended, either in whole or part, to mitigate the requirement to establish prudent provisions, and/or to provide an element of financing, the identifiable elements of the contract which do not transfer significant insurance risk are considered to be financial reinsurance."

The fundamental distinguishing features between reinsurance and financial reinsurance rested in the transfer or non-transfer of risk from one party to another. The 2003 SORP relating to financial reinsurance has been issued after the relevant period of the inquiry's review. However, it does provide a useful background to the facts that follow.

67. The Society's approach to reserving for annuity guarantees was in contravention of the regulatory requirement (regulation 64 of the 1994 regulations) that they had to reserve fully for the guarantees that they had written into their policies. One factor of importance in the controversy between the Society and GAD was the rate of take-up of GAR benefits assumed by the Society's valuation. The issue of reinsurance was approached by the Society as a solution to the problems faced in having to reserve for the guarantees in pre-1988 pensions policies. The treaty negotiated was conditional on Equitable maintaining its current bonus practice or something equivalent in cost terms.

68. The first recorded mention of reinsurance identified by the inquiry occurred on 3 December 1998 at a meeting between HMT, GAD and the Society, when Nash informed the regulators that the Society was considering reinsurance as a solution to their reserving situation. Although the contract could not be in place before the end of 1998, HMT agreed that it would be possible to give a post-dated concession to cover the 1998-year end position provided terms were agreed.

69. FSA, who were to assume the responsibility for prudential supervision of insurance companies from 1 January 1999, were advised around this time that if the Society were to reserve for near 100% of the annuity guarantees, as required, they would have only £1.1 billion in available assets to cover the RMM of over £900m (a cover factor of 1.24x), with £850m of the available assets being a future profits implicit item that could only be put towards 5/6 of the RMM:

70. In a letter to Nash on 7 December 1998, HMT contested the prudence of the Society's contention that reserving on the basis of a 35% take-up rate was prudent, and told Nash that they expected to see close to 100% reserving for such business. The letter stated that HMT would be willing to treat reinsurance as effective from the year-end provided that the terms of the agreement were in place by 31 December

[9] Statement of Recommended Practice, issued by the ABI, see chapter 10.

1998 and that intention to enter the agreement was demonstrated by the Society. It also stated that HMT expected to see an appropriate statement on contingent liabilities appear in the Society's regulatory returns "related to the risk of a successful challenge to the Equitable Life's bonus practice with regard to guaranteed annuities".

71. The Society informed HMT on 21 January 1999 that it had entered into a financial reinsurance agreement, with effect from 31 December 1998, enabling it "to reserve at a level which we feel prudently reflects our likely future experience". On scrutiny of the agreement, GAD identified a number of flaws[10], which were discussed at a meeting on 28 January[11] and accepted by Headdon.

72. There was extensive discussion of a provision of the contract that operated if the outstanding balance of claims under the treaty at any year-end, less prior repayments, exceeded £100m. Headdon stated at that meeting that the intention of the provision was to provide a right to review the treaty, but that, should no agreement be reached on revising the terms of the treaty, it would continue unchanged. The draft was amended in light of GAD's comments and was then sent to them to reappraise on 25 February, but there remained concerns about the clause that related to the settlement of claims.

73. The Society submitted its 1998 regulatory returns on 30 March 1999, as had been requested by FSA. The initial scrutiny by GAD was forwarded to FSA on 9 April 1999. It commented that Headdon was taking credit for non-take-up of annuity guarantees to a greater extent than GAD thought he should, but that the assumptions he had made were more prudent than he had suggested in the January Board paper he gave to them. However, the reinsurance meant that the solvency implications of this were negligible. The regulators had not yet seen a copy of the revised treaty, but on 27 April GAD reviewed a copy of the term sheet that Nash had sent in the meantime. GAD were content with the arrangements.

74. The scrutiny of the Society's 1997 and 1998 annual returns was completed at an accelerated pace at the request of the regulator and sent to the FSA on 20 May. Section 13 of the scrutiny report commented that the reinsurance treaty provided surplus cover for costs arising from the exercising of GAOs in respect of retirement annuity policies, individual pension plans and transfer plans issued before 1 July 1988. The report noted that if the proportion of retirement terminations where the guaranteed annuity option was exercised exceeded in any year 25% of the total terminations, measured by the guaranteed funds for those policies, the reinsurer's gross liability was equal to the guaranteed annuity policy fund for that proportion of retirements effecting the option, which was in excess of 25%. It was considered that the treaty enabled the Society's actuary to make a substantial offset to his GAO additional reserves (£800m off the gross £1.6 billion in the net premium valuation). It was noted elsewhere in the report that the Society's reserving assumptions were low at 70%, and that consideration should be given to challenging the appointed actuary on this issue. There was no statement on contingent liabilities as had been expected by HMT in their 7 December letter to the Society.

75. After some prompting, the signed treaty was finally sent to FSA on 14 October 1999, along with the Society's application for a section 68 order for a future profit implicit item. This was reviewed by GAD who, in a memo dated 22 October, informed FSA that the reinsurance treaty was in accordance with the terms that had been examined in April.

76. On 21 January 2000 the Court of Appeal decided two to one against the Society, but implementation of the judgment was suspended pending appeal. Nash

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[10] Firstly, it defined the cost of annuity guarantees incorrectly; secondly, either party had the right to cancel the treaty retrospectively, with the Society obliged then to pay any outstanding finance immediately; and thirdly, the reinsurance treaty limited total withheld claims to £100m at any 31 December or the treaty would be restructured.

[11] See chapter 17, paragraphs 103 to 105 for discussion of this meeting.

wrote to all policyholders on 1 February 2000 and informed them that there would be no significant costs to the Society should the House of Lords uphold the Court of Appeal's decision and that the Society would remain financially secure.

77. The immediate reaction of Hewitson, then directing actuary at GAD, to the judgment was that the regulators should confirm with the Society whether the reinsurance treaty was still valid. At a meeting held with the Society on 18 July 2000, it was made known that one of the possible outcomes of the appeal, which "had not previously been seen as a potential option", would affect the reinsurance treaty. This scenario, in which the ruling "did not allow the Society to alter the rate of bonus for policies that contain GARs", had emerged as a possibility following argument advanced by Sumption QC for Hyman and discussion during the hearing in the House of Lords. Under this scenario the treaty "would no longer remain valid". The reinsurance treaty was conditional on the Society maintaining its current bonus practice or something equivalent in cost terms.

78. If the treaty were invalid, it would have knock-on effects on reserving and the Society estimated that it would only just be able to cover its solvency margin (the year-end position was assets of £3.8 billion to cover a solvency margin of £1.1 billion). The Society would need to cover the additional benefits – which could be anything from £1 billion to £1.5 billion. The reinsurance would cover policies vesting three months after the judgment but would no longer protect the balance sheet. It was further noted that the Society had not sought reinsurance to cover the possibility of losing the case and that it had been the opinion of Headdon that it would not have been a viable proposition.

79. As events turned out, the worst-case scenario was reflected in the House of Lords' decision on 20 July 2000. On 26 July, Headdon wrote to FSA to inform them that on 30 June (not taking account of the Lords' decision but after bringing new resilience tests and regulations into account) the Society had excess assets of £2.1 billion above the RMM of £1.2 billion. After taking account of the judgment Headdon informed FSA that there was only £25m of excess assets above the RMM. He stated that the annuity guarantee reserve assumed 95% take-up – a figure he felt was excessive – and that a new reinsurance treaty was being considered to mitigate the problem.

80. Correspondence between GAD and FSA on an analysis of the reserving implications of the judgment commented that the form of reassurance that the Society had entered into was unique, having regard to its cancellation clause. GAD expressed the department's view that the actuary had acted imprudently in taking credit for the reinsurance, possibly relying upon the Board's view that (based upon the legal advice they received) they were unlikely to have to change their bonus policy.

81. The impact of the judgment was relayed by the Society to its policyholders on 2 August. Policyholders were told that no bonuses would be allocated to policies for the first seven months of 2000. The Society informed FSA of its solvency position (as requested), and also that no new reinsurance treaty had yet been agreed, although discussions regarding a revised treaty were progressing well.

82. At a meeting held with the Society at FSA on 11 August the sale process and the financial position of the Society were discussed. Headdon stated that a revised reinsurance contract had been negotiated and he provided details (an earlier addendum to the original treaty covering group pensions business was also provided). The previous policy was now defunct following the Lords' judgment since the GAR bonus policy had to change fundamentally, voiding the contract. The revised treaty assumed a much higher level of anticipated GAR take-up. He informed FSA that it would cover the Society for a GAO take-up level above 60% as opposed to the 25% level of the initial treaty. It was noted that the figures provided by the Society at this meeting showed that even taking into account the revised reinsurance protection, the RMM was still low with only £1.6 billion of explicit assets to cover a RMM of £1.2 billion.

83. On 1 September 2000, a signed copy of the addendum recording the revised terms of the treaty was forwarded to the FSA along with a copy of the addendum made in 1999 to bring group pensions business within the scope of the original treaty. These were forwarded to and reviewed by GAD, and on 21 September FSA were informed that GAD were satisfied with the amendments made to the reinsurance treaty. They highlighted that under the previous year's addendum, the deposit premium payable rose from £400,000 to £625,000 per annum. Under the most recent addendum, after the House of Lords judgment, the premium rose to £700,000; the Society was liable to meet the cost up to 60% of benefits being taken in guaranteed annuity form in any year (formerly 25%).

84. On 3 November, FSA had a meeting with the Society and GAD at GAD to discuss reserving issues. The Society reported that it had set up an additional reserve of £550m, or £200m net of reinsurance, to cover GAOs on new premiums, the worst case estimate being 2½ times this amount (£500m). FSA indicated to the Society that they wished to see the Ernst & Young valuation report prepared for potential bidders for the Society. GAD noted that the Society's minimal capital requirement was barely covered and that room for manoeuvre was slight in the event of a downturn in equity values. The Society had little option but to arrange its sale and demutualisation if it wished to remain open.

85. On 6 November 2000, FSA and GAD met with representatives and advisers of one of the potential bidders. Various issues were discussed with these potential bidders. On the topic of financial reinsurance, it was recorded that there was interest in the regulator's view of reinsurance secured on future margins and contingent loans secured on future surplus. It was noted that FSA stance on this issue would not support arrangements that amounted to regulatory arbitrage. The bidder's actuarial advisers observed that the Society's reinsurance treaty fell into that category. The bidder was also concerned that under the existing treaty, the reinsurer had the right to terminate the arrangement if the Society became insolvent. The minutes recorded that GAD were examining the provisions of the treaty in this respect. Shortly after this another bidder withdrew observing that they had found the financial position considerably worse than they expected.

86. On 16 November, Ernst & Young's valuation report was provided to FSA as promised on 3 November, along with an explanation of the reasoning behind the Society's calculation of the reserve for annuity guarantees. On 24 November, GAD's scrutiny report of the Society's 1999 annual returns commented on reinsurance:

> "The Society utilises a reassurance treaty with Irish European which provides protection to the Society should more than 60% (formerly 25%) of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options be taken in guaranteed form. This is not wholly satisfactory from a regulatory perspective as it relies on regulatory arbitrage to achieve the desired result, and would not be available in the event of insolvency. It removes over £1bn of liabilities from Equitable's balance sheet."

87. There was further correspondence between the Society and GAD concerning the requirement to reserve fully for annuity guarantees. Headdon felt the guidance on the issue was unclear. He contended that the relevant GAD guidance had stated that the effect of assuming less than a 100% take-up of GARS should not reduce the reserves held by more than 5% and that the Society approach was consistent with that. He further stated that the Society experience since the House of Lords judgment indicated that an 85% take-up figure was still a prudent assumption. Headdon stated that the guidance should have stated explicitly that insurers were to assume a take-up rate of 95% if that had been the intention. GAD commented in an email to FSA that the Society should increase its GAR reserve to 90%. GAD noted other factors relevant to the valuation and which would affect the Society coverage of its RMM. Removal of these factors would reduce the Society's RMM coverage from £1.1 billion to £70m. It also pointed out that if the reinsurance treaty were terminated, liabilities would increase by a further £1 billion.

88. At a meeting held on 16 January 2001, the Society set out its draft financial results for the year 2000. It was noted that it expected to show free reserves of £500m in excess of RMM. This included a provision of £1.8 billion net of reinsurance for annuity guarantees (the gross reserve being £2.6 billion). The provision had increased over the year by approximately £1.2 billion mainly as a result of the changes to the reinsurance treaty following the House of Lords judgment, lower assumed interest rates and an increased allowance for the payment of future premiums on annuity guarantee policies. The 10% market value adjustment that they had decided to impose was needed to cover the additional cost of the annuity guarantees following the House of Lords ruling, along with a poor investment return for 2000 (2½%) and the need to recover initial expenses (2½%). It was further noted that they did not wish to draw attention to the MVA and its link to investment conditions due to the possibility of adverse publicity.

The side letter

89. On 2 August 2001 Headdon wrote a memo to Peter Nowell, the new appointed actuary for the Society, concerning the ERC reassurance treaty, noting that he was replying to an earlier request for information on the £100m renegotiation clause in the agreement. Attached to this document was a set of documents including an extract of the draft treaty first submitted to the regulators. The extract was the provision dealing with the £100m renegotiation clause. It read:

> "In the event that the total withheld reinsurance claims balance exceeds £100m at any December 31 negotiations will take place to find a mutually agreeable restructuring of the treaty."

He also enclosed his own note of the meeting on 28 January 1999, which recorded that the regulators had "broadly accepted the £100m renegotiation point", a copy of a letter dated 1 February 1999 to the reinsurer requesting that changes sought by the regulators, the revised text sent to FSA on 19 February, and Hewitson's letter of 22 February 1999 recording the points that the Society had been asked to renegotiate. Headdon commented that the credit taken for the treaty in the 1998 and 1999 returns had not been queried, and he assumed the same was true for the 2000 returns.

90. On 7 August 2001 Nowell wrote to Hewitson informing him that he had made inquiries of Headdon and another senior actuary at the Society on the background of the draft treaty and for information relating to the £100m renegotiation clause in the agreement as part of his audit of Society. The information provided to him by Headdon led him to believe that the reinsurance treaty amendments, notably the £100m renegotiation clause, had been discussed with Hewitson.

91. Hewitson replied on 9 August. He told Nowell that GAD's understanding of this clause was that the treaty would not be cancelled if that event were to occur, but that negotiations would take place to restructure the treaty in a mutually agreeable manner. He further commented that their understanding from the early meetings on the treaty in 1999 was that the Society could not be forced to agree to a restructuring that had an adverse effect on the value of the reinsurance offset that could be included in the FSA returns.

92. At this stage events continued outwith my terms of reference. But they are important for a proper understanding of the position at 31 August 2001. There was further correspondence between the Society and FSA and on 24 September a copy of a letter of understanding concerning the reinsurance agreement, written by Headdon to the reinsurers on 1 April 1999, came to the regulators' attention. The letter stated that it was not intended to be a legally binding document, but its purpose was to clarify the intent of the parties. It recorded that it was intended that the treaty would be cancelled rather than renegotiated in the event that the £100m clause was triggered.

93. FSA issued a press statement on 26 November 2001. This commented that FSA had been unaware of the existence of the side letter, as had the Society's

auditors, and the Society's new management had only recently become aware of it. FSA further stated that this letter raised questions about the true value of the reinsurance agreement which was entered into the Society's 1998 annual returns, and that had they been aware of its existence, they "would not have been prepared to accept the reinsurance arrangements as providing as much security for reserving purposes as was in fact taken".

94. The press notice further stated that the Society had renegotiated its contract with the reinsurer, that FSA had seen and reviewed these revised terms and had no objection to them, and that the value ascribed to the contract was lower than the Society had previously taken. The press notice ended by stating that the Society continued to meet its regulatory solvency requirements.

95. The inquiry has seen a variety of papers from December 1998 onwards relating to the negotiation of both the treaty and the letter of understanding or 'side letter'. It was recognised by the Society from an early stage in those negotiations that a provision that enabled the reinsurer to cancel the treaty in the event that the outstanding balance of claims reached £100m at any relevant date (in the absence of a mutually agreed renegotiation) would limit to that amount the credit that could be taken for the agreement in meeting the regulators' reserving requirements. The proposition that there should be a parallel side letter was explicitly included in an email from the reinsurer to the Society on 22 January 1999. The suggested wording read:

> "In the event that the total withheld reinsurance claims balance exceeds £100,000,000 at any December 31 negotiations will take place to find a mutually agreeable restructuring of the treaty. However, should no mutually agreeable solution be found it is the understanding of both parties that the treaty will be cancelled as at the above said December 31. The portfolio at the date of termination will be withdrawn and the Reinsured shall refund to the Reinsurer at the same point in time any reinsurance Claims balance in full."

In a reply that day, a senior actuary at the Society reported that Headdon had agreed to provide the proposed side letter, but on the basis that the letter made clear that it was only an understanding and not a legal obligation. He suggesting inserting the words "which shall have no legal obligation whatsoever" after the reference to the understanding of both parties.

96. These matters are potentially the subject of other proceedings, so I do not propose to comment on what may or may not have been the intention in writing the side letter or its legal effect. Those involved at the Society were not in any doubt that a right for the reinsurer to cancel in these circumstances would undermine the regulatory value of the agreement. For present purposes it is sufficient to note the regulators' view that contemporary knowledge of the side letter would have influenced the view taken of the reinsurance arrangements and therefore the Society's regulatory solvency position. Again one had an arrangement of considerable complexity engineered to support regulatory solvency, and dependent on future profits for implement. The need to enter into such an arrangement was a further indication of the weakness of the Society.

<u>Regulatory treatment of the reinsurance treaty</u>

97. The side letter appears to have come as a surprise to regulators. But that apart, they were aware that the reinsurance treaty did not achieve any substantial transfer of risk. The premium of £150,000 was very low compared to the alternative offered by a rival reinsurer, and could not reasonably have been taken to have reflected a material transfer of risk from the Society to the reinsurer. ERC Francona's offer was subject to a loading on claims, but it was still expected to remove about £1 billion from the reserving requirements based on GAD guidance. Cologne Re had offered reinsurance at an annual premium of £20m to £30m. It should have been apparent that the Cologne RE offer was based on a true

reinsurance arrangement under which the risk would actually be passed to the reinsurer. Regulators understood that the transaction was a financing agreement.

98. In the course of maxwellisation, senior regulatory officers have emphasised that transfer of risk of liability was not the nature of the contract in Equitable's case:

> "The treaty was .. a financing operation. This was known and understood at the time by the regulator. In the Society's case the reinsurance treaty was an appropriate way of 'phasing in' the impact of the higher level of reserving that HMT rightly and firmly insisted on. It was a means of ensuring that the resultant cost, in the form of bonus cuts, was not imposed on a single generation of policyholders whose policies matured that year, but was instead spread over a period of years. It provided that the Society could draw down funds in years when the take-up of GARs exceeded a stated level with repayment to be made from future emerging margins. ...
>
> Thus the "risk" the treaty was intended to meet was not so much an increase in the take-up of GARs ..., but rather the non-emergence of margins in the future. Increase in GAR take-up was the trigger for drawing down funds...
>
> These reinsurance agreements then fall to be valued under the relevant regulations for the valuation of liabilities. Where these regulations allowed a value for the reinsurance agreement, then a firm and its Appointed Actuary can legitimately take credit for this agreement in its financial returns..."

99. These views require discussion. Setting the side letter aside, the treaty required renegotiation following the judgment of the House of Lords because the decision required a change to the Society's bonus practice. The implications of this aspect of the agreement do not seem to me to have received adequate consideration from the regulators. By accepting the treaty as the basis for off-setting against what would otherwise have been required as mathematical reserves, they were in effect accepting that it was sufficient for regulatory purposes to count an asset that would have value only if the Society had substantial success in the litigation. Even accepting that the Society was convinced of its case, it is hard to see how this treatment represented prudent practice. It failed to recognise the risk inherent in all litigation that the litigant on the other side may succeed. At best the contract offered contingent cover, and the contingency was dependent on a judicial determination of issues that the Society could not control.

100. As noted at the outset of this section, reinsurance normally involves the transfer of risk from one party to another. The reinsurance treaty negotiated by the Society involved no significant transfer of risk. In the first edition of the treaty, in the event of any claims being made, the Society would provide for the first 25% and the reinsurance treaty would take effect if the take-up of annuity guarantees exceeded this percentage. However, the Society was obliged to repay this capital from surplus when it was in a financially viable position to do so, according to the terms of the agreement. The agreement was a financing arrangement. In his responses to 'maxwellisation', Headdon has said that it is incorrect to say that the treaty did not transfer risk because, although the financial circumstances in which there would be an unrelieved claim on the reinsurer were relatively extreme, they did exist. I accept that that is a fair comment, but it rather damns the arrangements with faint praise.

101. In substance, in order to meet the regulators' requirements, the Society had entered into a financial reinsurance agreement that, in the view of regulators, allowed it to reduce the strain on its regulatory balance sheet. The reinsurance treaty was not intended to cover the situation where the Court found against the Society's differential terminal bonus policy. It was designed to protect the Society against a significant increase in the take-up of annuity guarantees under its existing bonus policy. This might have occurred in the event of adverse economic conditions resulting in insufficient terminal bonus or other factors. Allen noted in his statement to the inquiry that:

> "The suggested reinsurance treaty was a tool by which The Equitable could, quite legitimately within the relevant regulations, effectively reduce its statutory reserving requirements. Provided reinsurance could be found which was satisfactory to The Equitable and which met the requirements necessary to take the reserving benefit sought, it was perfectly permissible to do this, and was not an uncommon step for life offices to take. The decision to use the reinsurance option in this way is a commercial decision for a life office, and the regulator would have no grounds to intervene to prevent proper use, but the regulator would assess whether the reinsurance was effective to enable it to be used to improve the statutory solvency position of the company."

Other observations included the following from the senior line supervisor:

> "I understood that Equitable intended to offset the obligation to meet the additional costs of GAOs if take up exceeded 25% by passing it on to the reinsurer. Equitable would then pay back the reinsurer over time out of surplus. It was this risk that was assumed by the reinsurer, i.e. the risk that factors such as adverse economic conditions would result in insufficient surplus to cover repayments to the reinsurer. It was not intended that any risk of Equitable's bonus practice being found unlawful be passed to the reinsurer."

102. The most obvious initial criticism that can be made of the arrangements is that the Society made use of the treaty in its 1998 regulatory returns before agreeing the final terms of the agreement. The lack of a signed and approved version of the treaty would not have been fatal if there had been a completed slip or term sheet by 31 December. However, HMT gave the Society a dispensation to include this facility in their 1998 returns.

103. GAD had still not seen a copy of the signed treaty by 24 September 1999. It did not arrive until 14 October 1999. When the formal documents were provided, the Society did not provide the side letter. Regulators and GAD state that they were not fully advised of all relevant materials.

104. However it is necessary to return to the fundamental issue whether in any event credit was available in terms of the regulations. Regulation 64 of the Insurance Companies Regulations 1994 provides that in valuing liabilities account shall be taken of "any rights under contracts of reinsurance in respect of long-term business". As, apparently, understood by regulators, the Equitable treaty did not confer any rights in relation to the current long-term liabilities of the fund. It established no more than a contingent right to call down revolving credit in certain contingencies, involving at most a remote and limited risk on the reinsurers. It was little different in effect from the unexpired credit available for drawdown under any facility. If it came into effect and entitled Equitable to credit, it involved an equal and opposite liability to repay. Therein lay a degree of risk to the reinsurer: Equitable might not generate the surplus to repay. But that did not reflect a transfer of risk: it was an independent risk associated with Equitable's potential lack of available surplus.

105. In my view it is at least difficult, if not impossible, to bring this transaction within the scope of Regulation 64. Treating the contingent rights of the Society as a present asset appears to involve a very strained construction of the regulation. However, to the extent that the treaty was effective to permit set-off of, regulation 64 was applied to give credit for very substantial sums in a way that was disproportionate to the benefit understood by the Society and regulators to be conferred by the treaty.

106. Proposals have been made to make more focussed reporting on key aspects of life offices' financial positions the norm. On 1 December 2001, FSA introduced new requirements for information on group solvency, disclosure of transactions with connected parties and enhanced disclosure on the operations of with profits funds. Their discussion paper in November 2001 sought views on key information on the

financial condition and performance of with profit funds to be produced in a summary form with more transparent disclosure of reinsurance and capital support arrangements. It was hoped that these requirements would come into effect at the end of 2002.

107. In a consultation paper[12] issued in July 2002, FSA specifically considered arrangements where:

i. there may be no transfer of risk but where it is still possible to gain relief from capital charges;

ii. there is a genuine transfer of risk;

iii. there is a transfer of risk but the price paid for the transfer is a charge on future resources of the firm;

iv. there is no genuine transfer of risk but full credit is taken for the 'protection' purchased.

With reference to the situation that arises under point iv. above, FSA cited the following example in support of its views:

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

Problems associated with the Society's transaction, as understood by regulators, are being addressed. But the basic difficulties of accommodating the type of transaction within the existing regulations remain.

The Society's Use of Financial Adjustments

108. The Society's regulatory solvency position was supported over the period from at least 1993, and probably from 1991, by the use of the techniques discussed above. Of these the quasi-zillmer adjustment was, in my view, never appropriate. Regulators have published their view that disclosure of the side letter would have influenced the treatment of the reinsurance arrangements for solvency purposes, but I consider that the better view is that the contract did not meet the requirements of regulation 64 in any event. The future profits and subordinated debt adjustments were within the relevant regulatory provisions. But each depended for their prudence on the actuarial assessment of future profits sufficient to meet the emerging liabilities in the latter case and the cost of accelerating the emergence of profit in the former. To the extent that it may have been appropriate to take account of zillmerisation and financial reassurance, each again depended on emerging future profits. Taken together, these techniques presented considerable risk to the ongoing operations of the funds.

109. Individually, and in the aggregate, these adjustments removed the regulatory statement of the Society's financial position from the realistic position shown on the office valuation. The Society was able to meet the regulatory requirements by the use of these techniques because, in large part, it was known that regulatory scrutiny was concentrated on the returns and on solvency measured in terms of the regulations, with little, if any, attention to realistic solvency in the context of regulation. The publication of the Society's financial position on the regulatory basis,

[12] FSA consultation paper 144, A new regulatory approach to insurance firms' use of financial engineering, July 2002.

in its returns, assisted in deflecting from the Society the attention that would have followed disclosure to the public of that internal position.

CHAPTER 8: FINANCIAL POSITION OF THE SOCIETY AT 31 AUGUST 2001

1. The reference date for the inquiry is 31 August 2001, and the inquiry is not concerned with events after that time, except to the extent that they provide information about the financial position of the Society as at that date. The reference date, part-way through the financial year, does not coincide with any published statement of the Society's affairs.

Table 8.1: Internal with-profits fund valuation at 31 July and 31 August 2001

Office Valuation Basis: With-profits fund	**31-Jul-01**	**31-Aug-01**
	£m	£m
Net assets	**22,500**	**21,965**
With-profits liabilities at full value	19,303	18,893
Guaranteed annuity provision	1,257	1,257
Face value of guarantees	**20,560**	**20,150**
Accrued terminal bonus	1,340	1,330
Aggregate Policy Values	**21,900**	**21,480**
Funded Policy Value Position	600	485
Aggregate policy values as a % of net assets	**97.3%**	**97.8%**

2. The financial position at the reference date has been obtained from a Society Board paper produced by Nowell. Nowell effectively rolled forward the 31 July 2001 figures discussed in chapter 6, and as a result indicated a relatively static position. Assets were subject to a marginal decreases in value due to market performance and net outflows (claims in excess of premium income) while policy values grew by a rate of 6% per annum. Policy values expressed as a percentage of available assets remained relatively unchanged at 97.8%, up from 97.3% at 31 July 2001. While the policy cut of £4.9 billion in July produced a £600m surplus, this position was marginally eroded by 31 August 2001 to a funded position of £485m. While the Society was subject to adverse market conditions and net outflows, it was able to claw back value on non-contractual terminations. To the extent that both asset and more specifically liability values fairly reflected current economic risks and realities, the new Board would appear to have succeeded in restoring balance in the fund making the Society's financial position far more workable

Table 8.2: Balance sheet as at 30 June 2001

(from Compromise Scheme documents)	£m	£m
Investments		26,151
Reinsurers' share of technical provisions		352
Debtors and cash		595
Prepayments and accrued income		324
		27,422
Subordinated liabilities	346	
Fund for future appropriations	2,113	
Long term business provision	24,476	
	26,935	
Creditors and accruals	487	27,422

3. As compared with the position at 30 June 2001, there was a relatively static realistic position[1]. Since the material is in the public domain, and in particular in the hands of policyholders, I note that the Society published a superficially different picture at 30 June in the pro-forma balance sheet as at that date contained in the compromise scheme documents. Stripped of sums relating to linked business, that balance sheet indicated the position summarised in table 8.2 on the last page.

4. On the information available to the inquiry, these figures cannot be reconciled directly with the position set out in Nowell's presentation to the Board. Not least of the problems is that, the accounting bases were different. However, the explanation of the differences is primarily that the data in the compromise documents presented non-profit and with-profits liabilities as a single sum in the long-term business provision. I have received representations critical of the financial data contained in the scheme documents. It is appropriate that I should make clear that the financial information I have presented does not support any allegation of material miss-statement of the position of the long-term fund[2].

5. The notes to the pro forma balance sheet published in the compromise documents indicated that approval of the compromise would involve adjustments: the annuity guarantee provision of £1,454m and the provision for non-GAR claims of £270m would be removed and the liabilities would increase by £920m for the effects of the scheme, giving an overall reduction in liabilities of £944m. That was accurate, and appropriate adjustments were in due course made, but, of necessity outwith the inquiry reference period.

6. In the remainder of this chapter I shall comment on uncertainties that subsisted at 31 August 2001 about the financial position of the Society as it has been estimated already. The Society's exposure to claims was far from clear. The accounts at 30 June included a fundamental uncertainty note covering the financial obligations to GAR policyholders and the potential claims for mis-selling from policyholders most or all of which the approval of the compromise may have removed. But uncertainties remained regarding the provisions held for other mis-selling cases. The comments on possible claims that follow reflect that uncertainty and I cannot resolve it. But it is necessary to have some appreciation of the position that emerges from the information I do have and the representations that have been made to me.

7. As I have sought to make clear, my terms of reference exclude the resolution of disputes that ought properly to be dealt with by the courts. Thus, I have not in general been concerned with the legal validity or enforceability of claims that might lie against the Society at the instance of its policyholders, nor with the legal validity or enforceability of claims that the Society might have against third parties, nor with the legal validity or enforceability of claims that policyholders might have against directors or employees of the Society or any third party. The resolution of disputed questions of liability involves due process issues, other issues of procedural and of substantive law, and human rights issues that could not properly be the subject of an inquisitorial process. The courts alone have power to judge issues of breach of duty and of liability to pay compensation.

8. However, commentary on the financial position of the Society at 31 August 2001 would be incomplete without taking notice of contingent liabilities to policyholders at least in general terms. The legitimate interest of the inquiry is in ascertaining the facts, including how facts that might be, or might have been relied on in asserting such claims in litigation or otherwise came about. It is necessary also to distinguish claims that might be made against the Society from claims that might be made against third parties by the Society or by policyholders. A successful claim by the Society would increase the funds available to the with-profits

[1] Compare chapter 6, table 6.16.

[2] The comparative data for with-profits and non-profit and unit-linked liabilities is set out in table H.5 in the financial tables.

policyholders as a whole, or to some class of them. The appropriation of such funds would be a matter for the Society's current Board and might raise issues that could not properly be forecast. However, it is not for me to express a view whether or on what basis the Society might have a valid enforceable claim in the first place, for example based on a breach of duty on the part of the auditors. That would involve a body of evidence on proper auditing practice, in addition to basic factual analysis, and that could not properly be gathered and adjudicated on without full adversarial procedure.

Rectification Scheme

9. The first class of claims that was identified by the Society, and dealt with in the rectification scheme, related to policyholders whose policies contained annuity guarantees, but who had been or might have been denied the benefit of their rights on maturity or transfer between 1993 and the House of Lords' decision in the *Hyman* case. The identification of the need for a scheme of compensation for such policyholders was recognised in the course of contingency planning for failure in *Hyman*, and some aspects of the development of the arrangements have been described in chapter 5. The "blueprint" for a compensation scheme was discussed in conference with Elizabeth Gloster QC on 3 July 2000, when the basic idea of a "user-friendly" scheme to determine how compensation should be calculated was developed. The procedures envisaged from that stage included alternative dispute resolution if difficulties of quantification arose. The possibility of mounting a Companies Act scheme of arrangement was discussed and rejected, rightly in my view, given the difficulties of resolving individual policyholders' claims into coherent groups.

10. Also discussed at that meeting was the issue of claw-back from policyholders who had received or were receiving inflated benefits as a result of the policies that had been followed. It was resolved that that course was not open on practical and public relations grounds. Brian Green QC advised that the Society should assume that there was no issue as to guaranteed investment rates of return. The point had been before the courts, it had not been fully argued and any comment on it by the House of Lords would be obiter. Although all of the matters discussed were later debated at length and received the benefit of extensive advice from counsel, the meeting had laid out the general framework within which the business of the Society was taken forward in the events that happened. The elaboration of a scheme became a major operation for the Society and its advisers.

11. On 6 July there was a preliminary classification of possible claims that came to figure in later discussions. The groups identified were:

i. GAR policyholders who had taken benefits in GAR annuity form, who had a claim for debt or specific performance;

ii. GAR policyholders who had taken fund form benefits with the Society, who might have a damages claim for loss of opportunity to take annuity guarantee benefits, but would be offered the benefit of such an annuity from maturity and interest and would have no loss;

iii. GAR policyholders who had transferred their benefits to another provider, who may have been over-paid, but who might be offered a guaranteed annuity based on the excess of the guaranteed annuity which ought to have been offered over the annuity that was offered.

At the same date it was decided that claw back of previous over-payments was not commercially feasible. It was not practicable to try to sue former policyholders who had gone to other pension providers and it seemed wholly unfair to claw back from policyholders who had stayed loyal to the Society.

12. It was soon realised that the re-exercise of discretion year-by-year gave rise to fundamental uncertainties that could expose the whole exercise to challenge. At the

same time the taxation consequences of the proposals became problematical.. But a draft scheme was available by 14 July. The timing of the scheme became an issue, and there were competing views whether it should be implemented before a purchaser had been identified and had approved. On the one hand some wished to avoid a situation where the purchase price was reduced, perhaps heavily, on account of proposals already published which a purchaser viewed unfavourably. Another thought was that if a scheme were implemented and the court subsequently decided that it was inadequate in some respect, this might weaken the Society's financial position further and be against potential purchasers' interests. Headdon argued that the compensation liability had to be factored into the sale process. Formalising the proposals would enable them to be factored in decisively rather than as an unknown quantity. Secondly, there would be public relations advantages. Headdon also needed to have an idea of the liability in order to determine the revised rates of final bonus for each relevant year. A final decision was postponed pending consultation with Schroders.

13. Shortly before the advising of *Hyman*, matters became more formal. On 18 July, Leslie wrote seeking clarification of some of the financial aspects of the proposals. She commented:

> "More fundamentally, Andrew [Lenon] and I are unclear as to how the model you have drafted fits into the two stage article 65 structure whereby surplus is determined first and then apportioned between policyholders, Andrew has wondered whether the cost of the GARs impacts at both stages in the mechanism."

14. Lenon was junior counsel in the *Hyman* case. His comments explain some aspects of the reactions to the House of Lords' decision. The scenario that was to become relevant was the re-exercise of discretion following rejection of the Society's appeal. He advised that it would be necessary for the directors to re-exercise the power so as to re-declare final bonuses on a non-differential basis for GAR and non-GAR with-profits policyholders in respect of each of the years 1994 to 2000. The amount of bonus allotted would give rise to adjusted levels of benefit under the GAR annuities. As he saw it, policyholders enjoying GAR annuities would have a claim for an agreed sum in respect of the difference between the levels of benefit which they had actually received and the higher benefit payments to which they were entitled pursuant to the re-allotment.

15. Lenon advised that the readjusted levels of bonus and benefits payable under the GAR annuities would also be relevant to an assessment of the damages payable to policyholders. GAR policyholders might be entitled to damages for breach of the Society's obligation to allot final bonuses on maturity of their policies in accordance with the terms of their contracts. The prima facie measure of damages would be related to the value of the GAR annuities which they would have received, if bonuses had been allotted at the readjusted levels, though the readjusted levels of bonus would not necessarily be determinative of the amount of damages recoverable He commented on a range of problems relating to the assumptions on which directors could proceed.

16. The second issue which arose was whether, when re-determining final bonus rates for past years and/or in assessing damages payable to policyholders who took their benefits in past years, any downward adjustment could be made in order to take into account the additional liabilities/costs incurred by the Society as a result of the House of Lords' ruling. If no adjustments were made, the entire burden of the additional costs would fall on future generations of policyholders. Counsel advised that the accumulating cost of GAR provisions that would have been made over the period 1994 to 1999 could be taken into account, but that the cumulative cost of the compensation scheme could not. The second category of costs would not have been incurred if the Society had originally followed a correct non-differential approach to final bonuses, and they were not known about at the time the discretion was originally exercised.

17. The note contained an extensive discussion of the principles of restitution, and the effect of a judgment that permitted ring-fencing before turning to the position nearest that which eventually emerged: a decision that final bonus rates on fund form and annuity benefits had to be equal and that there could be no ring-fencing of GAR policyholders. Counsel advised:

i. GAR policyholders who had taken benefits in guaranteed annuity form, and had been allotted a reduced final bonus, would be entitled to be compensated for the difference (if any) between the value of the benefits which they have received and the value of the benefits which they would have been entitled to receive, had the Society followed a correct approach to the allotment of bonuses. He observed that if the Society had allotted the same rate of final bonus to all UK with-profits policyholders irrespective of the GARs, it would not have allotted bonuses at the higher-rate paid to the policyholders taking benefits in non-GAR form. There would have-been insufficient surplus to do so. Instead, the Society would have allotted a final bonus at a rate somewhere between the lower rate allotted to GAR policyholders taking guaranteed annuity and the higher rate allotted to the Non-GAR policyholders. The GAR Policyholders should not be put into a better position than they would otherwise have been solely by reason of the Society's breach of contract in operating a differential approach. If the issue were to be litigated, it would probably involve expert actuarial evidence, evidence as to the available surplus in the relevant years and (possibly) evidence from the appointed actuary and the directors of the Board in the relevant years.

ii. GAR policyholders who took benefits in fund form (either from the Society or from alternative providers) would have been allotted bonus at a higher rate than they should have been. However, these GAR Policyholders were likely to claim that, as a result of the Board's approach, they were deprived of the opportunity to take the more valuable GAR annuity to which they would have been entitled and that they are entitled to compensation in respect of the difference between the value of the benefits which they have received and the more valuable GAR annuity which they could have taken.

iii. In the case of all policyholders who had not yet taken their benefits, the Board would have to revise the bonus declaration for the current year, substituting a revised rate or rates for the current differential formula.

iv. Non-GAR policyholders who had taken benefits would have received more than were contractually entitled to as result of the Society's incorrect approach. Whether they had a defence to a claim for recovery would depend on the facts of the case and could not be determined by representative action. The Society would have to take a commercial decision as to the costs/benefits of pursuing claims for overpayments. In the case of policyholders enjoying benefits from the Society, the Society might be entitled to reduce future payments so as to bring them into line with the payments to which the policyholder would have been entitled had the benefits been properly calculated in the first place. That might attract litigation. But even if the prospects of clawing-back or deducting over payments were strong, the directors would be entitled to reach the conclusion, in the exercise of their management powers, that it would not be in the wider interests of the Society to seek to recover over-payments, because this would engender yet more damage to the Society's goodwill.

18. Counsel proceeded to discuss the vulnerability of the Society to claims based on misrepresentation. Possible claims were said to arise for:

i. rescission of any agreement made in reliance on the misrepresentation and return of any premiums paid;

ii. damages for misrepresentation under section 2(1) of the Misrepresentation Act 1967;

iii. damages for negligent misstatement;

iv. restitution of premiums and/or damages under sections 61 and/or 62 of the Financial Services Act 1986; and

v. damages for breach of collateral warranty.

He said that advice could not be given as to the Society's potential liability under these heads in the absence of concrete information as to exactly what representations were made to policyholders and as to what reliance, if any, was placed on them by policyholders. However, Nash's letter dated 1 February 2000 was said to be open to criticism on the grounds that it misrepresented the consequences of an adverse ruling by the House of Lords, both in terms of the costs of compensation and in terms of the Society's financial security. Similar observations were made about comments in the president's 1998 statement to members and in a 1999 question and answer document circulated to policyholders, according to which the directors expected that the additional cost of the benefits would not exceed £50m.

19. Counsel commented that there was no reason to assume that, if the House of Lords rejected the appeal, it would do so on a narrow basis that permitted ring fencing of GAR policyholders. Waller LJ held that ring-fencing would be permissible, but Lord Woolf MR had not done so and neither party had previously argued in favour of ring-fencing. If policyholders were able to show that they had placed reliance on misleading statements made by the Society when making premium payments, they might be entitled to return of the premium and/or to damages, subject to a range of defences open to the Society. Overall counsel's advice at this stage had covered a wide range of potential problems for the Society in the event of an adverse judgment. The financial position of the Society at 31 August 2001 would be affected to the extent that these matters had not been resolved in the interval.

20. On 24 July, Dentons sent the latest draft of what was still known as the benefits adjustment scheme to the Society. In a covering letter, the approach was explained:

> "In devising the scheme, we have had to take into account the fact that it is not practicable to put the relevant former policyholders in precisely the situation which they should have been in for a number of reasons, in particular the fact that it would not be practicable to claw back overpayments and thus restore the surplus to its correct levels in the relevant period, that the Society cannot determine accurately how a GAR policyholder would have decided to take his benefits on maturity had the discretion been exercised properly, and that the Society cannot procure that benefits taken with another pension provider on maturity are converted into a GAR annuity with the Society. The scheme tries to address these and other issues. However, because of these uncertainties, the risk of a challenge in principle cannot be overlooked."

The letter proceeded to outline the 'main areas of challenge' presented by the proposals.

21. A further revised form for the scheme was sent to the Society on 2 August 2000. On 9 August the solicitors wrote advising on the documents that might be sent to relevant policyholders and the approach to be adopted towards them. On 9 August, the Board of the Society decided to seek the endorsement of the rectification scheme from a panel of independent experts at that stage in the proceedings. Initial attempts to engage Lord Browne-Wilkinson failed, but he later accepted the appointment. Chris Hairs FIA, a former appointed actuary at Legal & General, was nominated by the president of the Institute of Actuaries. The panel was in place. Revision of the draft scheme continued.

22. Policyholders making enquiries were advised that a scheme was in preparation. On 20 September 2000 the Society wrote to a policyholder informing him that a scheme was being drawn up, and that as a result of the ruling in the House of Lords the options that had been presented at the time benefits were taken might have been wrong. The policyholder was told that the issues were complex and that resolution would take time. At this stage, the Society continued to operate on a going-concern basis in contemplation of the sale of the enterprise as a whole.

23. Implicit in the instructions on which counsel proceeded were the assumptions that what was envisaged was a set of proposals that would be the basis of individual negotiations on a case-by-case basis while the Society continued to carry on business as a going concern with-profits fund. It was also implicitly assumed that no other policyholder interests were affected. If it had been anticipated that there would have to be a compromise of all current with-profits policyholder rights prior to implement in full of the bonus adjustment, it is not clear how one group could have been dealt with on a full liability basis. The directors had proceeded to develop, and to take advice on, the rectification scheme. Headdon was responsible for the substituted bonus structures necessary to give effect to the judgment. He reviewed the board and investment committee papers for the relevant periods, summarised what appeared to him to have been the views of the Board and the appointed actuary and produced draft recommendations based on the state of knowledge at the time and without use of hindsight. The exercise was somewhat artificial: had the decision been known in 1993 the whole conduct of the business would have been different, and bonus policy investment strategy and the terms on which future contributions were accepted would have been different. However, history could not be re-written in those areas. The exercise was limited to adjusting final bonus rates. It appeared that the position was set for the panel of experts to proceed.

24. Progress with the scheme was then disrupted by a further controversy. On 5 October 2000 Browne-Wilkinson and Hairs had indicated an intention to endorse the draft scheme, but Brown-Wilkinson was then shown an article by Jeremy Lever QC, dean of All Souls College, Oxford, and recognised as a lawyer of great learning and distinction. The article, called 'Equitable Life: An Unnecessary Disaster', was passed to, but not published by, the Financial Times, but it was clearly in circulation. In the article, Lever argued that the decision of the House of Lords on ring-fencing was not so far-reaching as to render unlawful any discrimination which had 'the effect' of throwing part of the burden of providing annuity guarantees on to GAR policyholders, but only treated as unlawful provisions that had 'the object' of eliminating or decreasing the benefit of GARs to GAR policyholders.

25. Browne-Wilkinson wrote a note in which he disagreed with Lever's views, but stated that unless Lever was plainly wrong his intervention introduced a significant uncertain factor that had to be taken into account. He could no longer express the view that the scheme was legally fair. Brian Green QC disagreed with Lever. Green advised that there were no fundamental principles of mutuality which could be invoked to achieve the result for which Lever contended in his article. He confirmed his advice in a note dated 12 October. There were further comments by Ayliffe the same day, and Lenon provided a critical opinion the following day. There was also an opinion from Gloster, dated 15 November, which dismissed Lever's arguments. In sum Lever's views were subjected to close scrutiny and analysis. The directors were advised that Lever was wrong.

26. It appears that it was subsequently ascertained that Lever had changed his opinion and accepted that the House of Lords had intended to rule that the directors had no discretion to allot differential final bonuses. Hairs issued a report endorsing the scheme on 1 December. Browne-Wilkinson issued a report endorsing the rectification scheme on 5 December. The Board approved the scheme formally on 7 December, at the same meeting as it resolved to close to new business[3].

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[3] See chapter 5, paragraph 100.

27. The scheme document was issued. It narrated that it had been endorsed by Browne-Wilkinson and Hairs. It narrated the re-exercise by the directors of their discretion to fix levels of final bonus for the 'relevant period', defined as the period from 1 January 1994 to the earlier of 19 July 2000 and a selected pension age earlier than 20 July 2000 but chosen on or after that date. The scheme covered 'relevant policyholders', defined as persons interested in GAR policies whose benefits matured in the relevant period and who arranged to take retirement benefits under the policy in that period. The overall purpose of the scheme was to set out a process by which the relevant policyholders could review the choices they made at maturity in the light of the new bonus resolution made by the directors.

28. Relevant policyholders who had taken benefits in non-GAR form with the Society and those who had taken benefits with another pension provider were subject to the 'specified condition':

> "The Specified Condition is that the Relevant Policyholder demonstrates to the satisfaction of the Society or, failing that, to the Independent Assessor referred to in paragraph 22(b), (or, if the Relevant Policyholder chooses not to involve the Independent Assessor, to the Court], that he/she would have taken benefits at policy maturity date in a form to which GARs apply if the applicable New Bonus Resolution had been in force at that time."

The document set out a claims resolution procedure and provisions for implementation for each individual policyholder. It was stated that the document did not constitute an offer or an invitation to enter into any commitment or agreement. Subsequently the Society would write to each relevant policyholder setting out how the scheme applied in his/her individual case.

29. It is of some importance that the 'specified condition' was explicit in the scheme from the outset. I have received representations that this was impossible to satisfy and fundamentally undermined the scheme . However, the scheme, as drafted, was envisaged as a scheme for compensation for loss that might otherwise be established in ordinary litigation. In that context the specified condition gave expression to ordinary legal principle.

30. The result, as at 31 August 2001, of the decision to publish the rectification scheme is difficult to assess. The scheme as a whole was developed when it was assumed that the Society would remain a going concern open to new business, though when it received Board approval a decision to close to new business had already been taken. It recognised only the rights of annuity guarantee policyholders whose policies had matured in the relevant period to be put as near as might be in the position they would have been in but for the differential terminal bonus policy. In providing for those policyholders the opportunity to re-assess their own positions, and, if thought appropriate, to take increased benefits, the Society disturbed the balance between the relevant policyholders and current policyholders whose rights had not matured by 20 July 2000, and who could not thereafter exercise a contractual right to select a pension age prior to that date. The latter group were vulnerable to all of the losses associated with the events of 2000, but had only the benefits available under the compromise scheme as it came to be developed, apart from the right to sue independently in some cases.

31. The scheme subsisted at 31 August 2001, and it was a material factor in describing the Society's position in the context of the compromise scheme. The Society earmarked £200m for the rectification scheme. In the 2001 accounts, this provision was increased to £420m. It remained at that level in the 2002 interim accounts. However, in the 2002 accounts published on 31 March 2003 it was made clear that the then current Board did not intend to proceed with the scheme. It was stated:

> "At the time of publication of the Interim Report last November, we announced that we were carrying out a review of the overall administration of the GAR rectification scheme. It became increasingly obvious during 2002 that the

original proposals, launched by the Society's former Board, to compensate holders of GAR policies who retired before the House of Lords' ruling in 2000 needed to be changed.

This review is now well advanced and has revealed that the original scheme is very complex, time-consuming and may not be fair to continuing members.

As a result, we have now decided to withdraw the current scheme and are now assessing alternative approaches that will speed up and resolve the long-standing need to provide appropriate, fair compensation for eligible policyholders in a sensible time scale. We will send details to those affected as soon as the proposals for the alternative scheme are completed, which will be within the next several months."

32. At 31 August 2001, there was an identified contingent liability to the relevant policyholders for which provision required to be made. Since I have been denied free access by the current Board to papers relating to the period after 31 March 2001, it has not been possible to form an independent view on the estimates made at that time. But there is one point of some significance that does not depend on quantification. The existence of the scheme provided a basis for dealing with one identifiable class of potential creditor of the Society: the relevant policyholders. Had the scheme not been in place as the Society proceeded with the compromise scheme, provision for these policyholders would have been required. As it was their claims were recognised in the financial provision of £200m published at that time.

Compromise Scheme

33. I shall not comment on the merits of the compromise scheme, nor on the procedural requirements approved by the court in the section 425 proceedings. But the documents circulated by the Society provided valuable information on which I may properly draw in describing the position of the Society at the reference date, and especially information about claims against the Society. The documents identify possible heads of claim that were resolved by the scheme, and assist in identifying other heads that were not. Claims between policyholders and third parties were not dealt with in the compromise scheme, and some potential claims between the classes of policyholders involved in the scheme were not disposed of. The guaranteed annuity policyholders accepted a reduction in their rights derived from the *Hyman* decision. But other groups of with-profits policyholders have asserted that they have reserved the whole right to benefit from any recoveries from third parties.

34. In a joint opinion provided to the Society on 10 May 2001, Nicholas Warren QC and Thomas Lowe ("the first Warren opinion") expressed preliminary views on a range of claims that might lie against Equitable at the instance of policyholders. A further joint opinion by the same counsel was provided to the Society on 12 September 2001 ("the second Warren opinion"). Equitable also obtained separate advice in a joint opinion by Gabriel Moss QC, David Richards QC, Martin Moore and Barry Isaacs dated 19 September 2001 ("the Moss opinion"). FSA instructed Ian Glick QC and Richard Snowden to advise on a range of similar issues. Their joint opinion was issued on 19 September 2001 ("the Glick opinion"). These opinions did not deal with possible claims against third parties. In particular, the written advice did not contain observations on claims that might lie against Ernst & Young, the Society's auditors; former directors; regulators; or any independent financial advisers. There were thought to be fringe activists who might raise wildcat proceedings as individuals or as small groups. But there were also larger policyholder groups who might resort to class actions. A claims company was known to be active in persuading policyholder groups to initiate proceedings. They had already raised proceedings against other providers in the industry.

35. These were the parties identified for the inquiry's benefit on Thursday 6 September 2001 by Sir Howard Davies as possible targets for claims that FSA believed would remain outstanding after any compromise, on the understanding

that the compromise settlement would not attempt to resolve any claims against third parties. These would be left over for Equitable to pursue as a company or for the individual policyholders and groups to pursue against the Society. But, generally, in proposing the compromise scheme, Equitable wished to close down as many independent claims as possible, in the interests of finality. Herbert Smith had been instructed to consider and assess all possible claims.

36. The second Warren opinion summarised the authors' views on liability, quantification of damages, and limitation periods under a number of heads. The Moss opinion expressed the authors' views on the same range of issues and further commented on certain differences of opinion that they had noted. However, the issue for the inquiry has not been whether one or the other of these, or the Glick opinion, was a more accurate assessment of the legal position. My concern is solely with the impact of claims on the position of the Society, and that is not likely to be instructed primarily by a correct view of the law as much as by a proper accounting view of the requirement to make proper provision for the claims as they might have been perceived from time to time over relevant periods.

37. Dealing with claims affecting Equitable, the Society described the legal advice received in its statement 'Background to the Proposed Compromise' issued on 20 September 2001 in terms that seem to me adequately to set out the position of the Society on the advice that had been received:

> "The Society has received legal advice from Nicholas Warren QC and Thomas Lowe, in the form of a joint opinion (the Joint opinion) that policyholders who do not have GARs have potential claims against the Society because they were not made aware of the existence and potential impact of GAR rights in policies previously issued by the Society.
>
> The potential claims identified by Nicholas Warren could be brought not only through the courts but also to the PIA Ombudsman. Alternatively, the Financial Services Authority (FSA) could compel the Society to put in place a scheme for compensating non-GAR policyholders under the rules of the Personal Investment Authority (PIA Rules).
>
> An estimate of the cost of defending any action and of meeting any successful claims would have to be made. A suitable sum would have to be set aside from the with-profits fund before any profits were made available to allocate bonuses to policies.
>
> 4.1.1 Potential heads of liability
>
> The joint opinion identifies a number of potential heads of liability under which a non-GAR policyholder might be able to make out a claim against the Society for a failure to disclose the existence of the GAR liability, namely:
>
> - a breach of the regulatory rules, giving rise to a breach of statutory duty under section 62 of the Financial Services Act;
> - statutory or common law misrepresentation or negligent misstatement or advice under the rule in the legal case of Hedley Byrne v Heller;
> - implied warranty/collateral promise;
> - estoppel by convention; and
> - unfair prejudice under section 459 of the Companies Act.
>
> The joint opinion does not consider the availability of any particular remedy on a policy by policy basis but instead examines the heads of liability by reference to the general facts in existence at any relevant time. The joint opinion also examines the extent to which such claims might be statute barred or otherwise limited by law.

> The Society notes that the description in the joint opinion of the prospects of success of each of the potential claims varies from "substantial case", "may well be established but ... not uncontroversial", "may ... on a case by case basis ... be able to establish", "may be possible" and "reasonably arguable case". The Society also notes that overall, the joint opinion concludes that there is a likelihood that some claims exist against the Society for some non-GAR policyholders and, potentially, for substantial amounts, and that it also acknowledges that there will be difficulties evaluating the claims on an individual basis, taking into account the existence of any defence of limitation open to the Society (actions becoming time-barred), the need to demonstrate factual reliance on the Society's alleged misrepresentation and the assessment of the quantum of loss any one policyholder has suffered.
>
> Indeed, it is the Society's view, having taken further legal advice from Gabriel Moss QC that, despite the substantial arguments that there are potentially significant claims against the Society, it is not possible to be sure that any particular non-GAR policyholder has a definite claim against the Society for any particular sum.
>
> 4.1.2 Quantum of damage
>
> Nicholas Warren QC has addressed the issue in his opinion of whether the damages suffered by a non-GAR policyholder should also include the consequences of similar claims that might arise from other non-GAR policyholders leading to lower bonuses in the future. The effect on damages would in such circumstances be significant in terms of the quantum of the claims. For example, if all non-GAR policyholders could frame their claims as negligent advice and if Mr. Warren is correct in his view of the law, then the cost of the claims would fall largely on GAR policyholders and would include the costs of consequential loss arising from the claims of other non-GAR policyholders. Mr. Warren accepts that this is a difficult question that depends on the nature of the cause of action. The issues presented in Mr. Warren's opinion are complex.
>
> The Board has considered Mr. Warren's opinion on the matter very carefully. It has also reflected on the views of other leading Counsel Gabriel Moss QC who does not agree that a non-GAR policyholder could recover this type of consequential loss.
>
> The Board has concluded that the cost of compensation to non-GAR policyholders for potential claims is more appropriately treated as a cost for all policyholders to bear. This is analogous to the treatment of the cost of GARs subsequent to the House of Lords' Judgment."

Turning to the non-GAR policyholders' claims, the Society's statement said:

> "4.2.1. Types of claim and compromise
>
> The existence of the different heads of liability will be affected by the application of any relevant limitation periods and, therefore, the timing of the relevant key events which gave rise to any potential liability. The analysis of the factual matrix and the different heads of liability will therefore give rise to a different range of claims for each non-GAR policyholder."

The document rehearsed a range of possible means of dealing with non-GAR claims including:

> "4.3.3. Incorporate a generic compromise of the non-GAR policyholders' claims into the solution proposed in the scheme.
>
> This option is technically challenging, but offers the prospect that a single scheme will resolve all the fundamental uncertainties arising out of the GAR problem. This is likely to be attractive to policyholders as it provides the greatest degree of finality of all the options."

38. A summary of the Glick opinion was issued by FSA the same day. It said:

"Ian Glick QC and Richard Snowden were asked to advise the FSA upon a preliminary basis. They have not made any findings or pre-judgments concerning Equitable Life or anyone connected with it. They have advised primarily on the basis of the documents produced by the Society for its policyholders and their Opinion does not cover the consequences of any further representations which may have been made by the Society or by its salesmen in individual cases. Their Opinion is summarised in the following paragraphs.

1. There is an arguable case that the Product Particulars, Key Features and With-Profits Guide documents produced by the Society breached the Lautro and later the PIA Rules by failing to disclose that some of the existing policies written in the with-profits fund contained terms providing guaranteed annuity options and that there was a risk that if current annuity rates were to fall below the guaranteed annuity rates used in those policies, this could materially affect the bonuses payable under their policy ("the GAR risk"). This would give rise to a claim under section 62 of the Financial Services Act 1986.

2. It is uncertain how early such disclosure should arguably have been made and thus how far back such breaches may go. It is possible that they may go back as far as 1988. There is certainly an arguable case that disclosure should have been made at some point in 1993, which was the year when current annuity rates first actually fell below the Society's guaranteed annuity rates, provided that it was then foreseeable that the potential impact of this on bonuses might be material.

3 It is also arguable that the Society's Key Features document, which first appeared in 1995, implicitly represented that the non-GAR policy on offer was not subject to any material risk factors other than those which were listed. From the time the GAR risk ought to have been disclosed in that document, such implicit representation was untrue, and it is arguable that the Society did not have reasonable grounds for that implied representation. This would give rise to claims under section 2(l) of the Misrepresentation Act 1967 and for negligent misstatement at common law.

4. It is also arguable that from the time at which the GAR risk ought to have been disclosed under the Rules, if the Society, through its representatives, gave advice to a prospective policyholder as to the suitability of the non-GAR policy for him, the Society may have breached a common law duty to take reasonable care to ensure that such advice was accurate. This would give rise to a claim in negligence.

5. To succeed, non-GAR policyholders will have to show that they were induced to take their policies or make voluntary contributions by the Product Particulars or Key Features documents, or by any advice given by the Society's representative, or by the With-Profits Guides. If they would have taken the policy from the Society or made the further contribution in any event, they will have suffered no loss and have no claim.

6. Causes of action arising from acquisition of a non-GAR policy would probably accrue on taking the policy. Causes of action based upon the making of voluntary contributions to existing policies would accrue when the contribution was made. The basic limitation period for these causes of action is six years from accrual, after which the causes of action are barred by statute. However, common law actions for negligent misstatement or negligence will probably not become statute barred until three years after the House of Lords delivered its judgment in June 2000.

7. Although this is a difficult and controversial area, and the contrary is arguable, the Society should only be liable for damages to the extent to which it can be shown that the reduction in value of a non-GAR policy in comparison

> to a similar product from another company is attributable to the undisclosed GAR risk. The Society should not be liable for any other adverse consequences of a non-GAR policyholder having bought his policy from the Society, such as any general under-performance of the Society's with-profits fund in comparison with other companies, or any diminution in bonuses attributable to the fact that the Society may have incurred mis-selling liabilities to other policyholders.
>
> 8. In relation to claims under section 2(l) of the Misrepresentation Act 1967, as the law presently stands damages for all of the consequences mentioned above would be recoverable. However it is arguable that the measure of damages under the 1967 Act should be the same as for other negligent misstatements, and there is a strong chance that the authority to the contrary will in due course be overruled.
>
> 9. In general non-GAR policyholders are not likely to have contractual claims for breach of warranty, breach of a collateral contract or founded on an estoppel by convention. They are also unlikely to be able to petition the court successfully for unfair prejudice under section 459 of the Companies Act 1985."

39. In summary, the second Warren opinion in its final form indicated that there was substantial scope for claims against the Society, especially those based on allegations of mis-selling, even if the advice was not definitive of the answers to the questions that might arise. At 31 August 2001 his assessment of the situation could have resulted in the kind of impasse that could only be resolved by litigation or liquidation failing compromise. In the second Warren opinion it was stated that there was

> "... a substantial case that the sale of all non-GAR policies issued since the Society first became subject to LAUTRO rules in 1988... involved a contravention of those rules",

and therefore gave rise to a possible cause of action under section 62 of the Financial Services Act 1986. The argument was said to be stronger in the case of policies issued after the emergence of the risk that current annuity rates were likely to fall below the guaranteed rates, and at its strongest after the Court of Appeal judgment in Hyman. The Moss opinion rejected the reasoning on which this view was expressed. The Glick opinion, based on different reasoning from Warren, was that there was an arguable case that the Society's marketing material had breached the LAUTRO and later the PIA rules, giving rise to a claim under section 62 of the 1986 Act.

40. Notwithstanding the contrary Moss opinion, it seems reasonable to state that immediately before the issue of the compromise proposals, Equitable was vulnerable to litigation based on allegations of breach of the LAUTRO and PIA rules resulting in liability under section 62 of the 1986 Act. The second Warren opinion also expressed the view that there was a case that the Society was liable for negligence at common law and in terms of section 2(1) of the Misrepresentation Act 1967 in respect of the manner in which it made representations to non-GAR policyholders.

41. It would be inappropriate me to express any view on the competing opinions. On any view there was a significant contingent liability for damages to a range of non-GAR policyholders that would have had to be assessed and provided for, or noted, in a way that would have impacted on the solvency of the Society over the material period. Whether or not the initial breaches would have been identified in 1988, quantifiable loss would have first emerged in 1993, and should have been provided for thereafter. It is impossible to offer any view on what the appropriate amounts would have been, but they would not have been insignificant, especially given the weak position of the Society generally. The compromise scheme sought to deal with the non-GAR claims, and to the extent that it succeeded removed that

factor from the liabilities of the Society for the future. But, absent the compromise, proper provision for these claims would have been required.

42. The potential costs involved were calculated by Nowell in connection with the compromise scheme. In respect of future GAR costs, he wrote:

> "3. The Proposed Scheme of Arrangement
>
> 3.1 Introduction
>
> The proposed Scheme crystallises the Society's liability to its GAR policyholders in respect of their rights to GARs by removing the GAR rights policyholders could enjoy on retirement for immediate increases in their policy values and guaranteed benefits, reflecting their various GAR rights. The Scheme will also cause any GAR-Related claims either GAR or Non-GAR policyholders could bring against the Society and/or its associates to be waived. Non-GAR policyholders' funds would also enjoy immediate increases as a consequence.
>
> 3.2 Quantifying the realistic estimate of future GAR Costs
>
> The starting premise for the actuarial work was that fair value compensation for the GAR policyholders should be a realistic estimate of the additional cost to the Society of providing GAR benefits in the future. The estimate should be neither optimistic nor cautious, and should use best estimate assumptions of future experience. Wherever possible, these assumptions have been set after appropriate reference to relevant past experience, with adjustments where necessary to remove any distortions.
>
> Key considerations included:
>
> (a) the level of current and future interest rates;
>
> (b) anticipated investment returns on the with-profits fund;
>
> (c) the proportion of benefits taken in GAR form (the 'take up rate') The basis assumes a rate of approximately 60 per cent. which is based on the Society's experience for the period from September 2000 to July 2001;
>
> (d) the level of future contributions attracting GAR rights;
>
> (e) future mortality, including allowance for prospective improvements in mortality;
>
> (f) future transfers out of the with-profits fund;
>
> (g) a discount rate that is used for discounting the capitalised value of the annuity at retirement to the current date; and
>
> (h) the expected distribution of age at retirement.
>
> As a result of the work carried out, the estimated realistic value for the GAR costs was £1.06 billion based on the GAR Funds as at 31 July 2001."

In relation to the non-GAR claims dealt with in the compromise scheme, he wrote:

> "3.4. Quantifying and allocating the potential Non-GAR Claims
>
> The method of quantifying the potential Non-GAR claims is largely a legal question and a decision for the Board. However, from an actuarial point of view an approach that restores the direct effect of the House of Lords' judgment on policyholders seems sensible, and this is the approach that has been used. My report explains how the appropriate level of compensation for Non-GAR policyholders was estimated to be £220 million, taking into account the probability of success of potential claims, and the fact that about 75 per cent. of any compensation would end up being paid for by the Non-GAR

policyholders themselves. Based on the legal advice obtained, I am satisfied that the Board's view is fair and reasonable."

43. On this approach, the claims by the guarantee annuity policyholders and by those not entitled to annuity guarantees compromised under the scheme had a value of £1.28 billion at the date of the scheme document, effectively the position following the application of the 16% reduction on 30 June 2001 values intimated on 16 July 2001. This remains the best evidence available to me of the financial position dealt with in the compromise scheme.

Claims Arising from Policy Guarantees

44. General discussion of the annuity guarantee issue has tended to overlook the fact that guarantees were explicitly or implicitly reflected in a range of the Society's with-profits products, and in its non-profit products. In the case of non-profit business, the liability was typically specified in the policy and had to be met at maturity. Reserves had to be set at an amount which, together with future premiums, would produce returns that met future expenses and liabilities as they fell due. In the case of with-profits business generally, the premium scales were constructed by adding together a charge for the basic benefit and a loading for profit. For instance, in the mid-1980s endowment assurance premium scales reflected a charge based on net interest of 6% for the guaranteed sum assured together with an allowance for future bonus. Guarantees were not solely related to deferred annuity business.

45. In bonus class B7, which covered recurrent single premium contracts for UK pension business, basic life assurance and general annuity business and certain international and Irish business, there were explicit guarantees, of increased benefits by way of interest and other additions, generally for the period between the valuation reference date and payment. The Society reduced the final bonus otherwise payable to cancel the benefit of these provisions. Further, in the case of retirement annuity and other relevant deferred annuity business, the guarantees were not confined to the conversion rate in possession.

46. There was an issue in the preparations for *Hyman* whether orders should be sought in relation to the 3½% roll-up rate of interest that applied to most of the business for most of the durations involved. It was decided that the issue should not be dealt with in *Hyman*. The question was specifically focused for counsel's advice:

> "So far, the attention of policyholders and the media has focused on GARs. Leading Counsels' views are, however, sought as to the appropriateness of the Society's approach in relation to guarantees other than GARs and their recommendations as to the future exercise of the directors' discretion in relation to such guarantees and the strategy to be adopted. For example, if the Society commences proceedings in order to obtain clarification as to the future exercise of the directors' discretion in relation to GARs, should the relief sought relate to guarantees other than GARs, or would the formulation of the relief sought in the proceedings be broad enough to cover such guarantees.

47. As discussed more fully earlier, until the 1990s with-profits business was priced and valued on a basis that reflected the right of the policyholder to an implicit or explicit rate of investment return on premiums and other accrued guaranteed benefits. The Society then introduced contracts that excluded these guarantees. For example, from 1996 with-profits pensions business was written without the 3½% guaranteed roll-up rate of interest that had been explicitly provided in the policy documents from 1988 and implicitly before that from October 1975.

48. The Society's view came to be that the guarantees were merely elements of the total return to policyholders. In a memorandum dated 28 June 1996, Ranson said:

> "The overall guarantees in any one year are provided by a combination of the guaranteed rate of interest and the declared reversionary bonus rate for that

> year. This system has been discontinued by the market generally in favour of a single overall reversionary bonus rate."

The Society was moving in the same direction, and discontinuing guarantees in new business. But it was the intention at that time that the same overall rates of return would apply to the new contracts as to the old. There should be no difference between the total benefits accruing. The result, however, was to treat the policy guarantees as if they had the same character as declared bonus. No material reserving considerations were recognised. Both elements were reflected in the mathematical reserves and technical provisions. The investment return was a straightforward contractual obligation, explicit after 1988 in pensions business, and implicit in earlier contracts of that class and in endowment and other forms of with-profits life assurance. The reversionary bonus became a contractual guarantee on being declared. They were, however, of different character in contractual terms.

49. This did not become an issue in *Hyman* perhaps because, in the course of the proceedings, Sumption conceded that the guaranteed investment return rates were a different issue from the guaranteed annuity rates. The concession effectively prevented any discussion of the issue. But from 1996, when the Society introduced contracts with no guaranteed roll up rate of interest, explicit or implicit, distribution practice had changed. Bonus declared on contracts with guaranteed investment roll-up rates was fixed at reduced relative to the declared rate by the amount of the rate of investment return. There was a risk that it might have been argued that the policyholders in question were discriminated against on the ground that they had a contractual right, and deprived of the benefit of that contractual right by differentiation in the level of declared bonus.

50. The question was considered by Gloster and Lenon on 4 September 2000. They advised that there was no substance in the argument:

> "4. ...On a correct construction of the relevant policies, the essential features of GIRs is to ensure that, whatever the actual rate of return achieved by the Society, policyholders are guaranteed a certain minimum rate of return. Provided the actual rate of return achieved by the Society is equal to or in excess of this contractual minimum .., the GIR does not 'bite'. The Society is free to adjust bonuses so as to bring the benefits of policyholders into line with the actual rate of return, whatever their (lower) GIR.
>
> 5. In our view, there are no grounds for implying a term ... that policyholders with higher GIRs would receive the same rates of bonus as policyholders with lower GIRs, so as to create a differential in the value of the benefits available on maturity of the policy. Such an implication would not be supported by the express terms of the policy and would alter the character of the benefit conferred by the GIR.

51. As I have said earlier, there is, in my view, no objection to a life office discriminating between policy classes on grounds that take account of differences in guaranteed benefits when making bonus allocations. If the cost of the guarantees is properly reflected in the premium bases, the amount of premium to which the bonus is related is affected. Provided that the return available overall exceeds the guarantee the aggregate of the elements of the return to policyholders may be the same where there is a guaranteed rate of investment return as the bonus in the case of business carrying no guarantees for the same level of premium. In most cases I would agree with counsel I the result if not the analysis that supports it. Thwe Society's forms of retirement annuity policy at no stage referred to guaranteed rates of investment return, nor did they define their role. Initially, as I have discussed, the investment return and the conversion rate in possession were merely arithmetical factors taking into account in determining the specified annuity, in combination with the expenses deduction and mortality assumption. Bonus was provided for separately, as a means of generating additional elements of annuity value. The implicit guaranteed rate of investment return always 'bit': it was an element in the

annuitant's basic entitlement. The variable element was the bonus annuity. The issue was as to the scope of the Board's discretion in determining those rates.

52. However, it would not be practicable to comment on the implications for the Society's financial position of arguments that might be advanced relative to this and other guarantees. Ministers made it clear that it was not the function of my inquiry to offer views on the compromise scheme relating to the annuity guarantee policyholders' claims. While the approval of the scheme of arrangement perhaps marked a stage after which I could not in any real sense express an opinion on that matter, my view has strengthened over time that I should make no comment whatsoever on the compromise. Without that context, discussion of other potential guarantee-related issues would run the risk of producing pointless speculation. In the result, I cannot offer any view as to the potential for claims against the Society based on allegations related to the Society's practice in dealing with policy guarantees generally.

Claims Unrelated to the Annuity Guarantee Issue

53. In addition to the information provided by the analyses in counsels' opinions set out above, I have received complaints from a large number of policyholders. Many have repeated criticisms of the regulation of Equitable, and of the performance of the Society's auditors. I shall have regard to the comments on regulation in context, and do not repeat here the observations that have been received in correspondence. I shall also made clear my position in relation to complaints against the auditors, which, so far as material, are the subject of the current litigation. There have been comments on the House of Lords' judgment. It would not be appropriate to rehearse policyholders' complaints on these matters here. I shall, however, seek to describe and illustrate the complaints against the Society.

54. Some policyholders have raised specific issues relating to their own cases. Some have raised general issues. The proper forum for most of these complaints is the complaints procedures established under the legislation . My concern with them relates to the financial position of the Society at 31 August 2001. I have not sought the views of the Society on these claims, nor otherwise sought to elicit information such as one would naturally receive in adversarial proceedings, and do not consider that it could be appropriate for me to offer any views on their validity or value. So far as the Society is concerned, I consider that it rightly views its position in relation to existing and potential claims as confidential: it would be unlikely that the Society would disclose a position in response to me that could jeopardise its negotiating position or alternatively its defence in adversarial proceedings. I have sought clarification of the basis of complaints in some cases, and I have sought the assistance of selected policyholders in forming an impression of the quantification of their complaints if they were upheld, since in appropriate circumstances that would reflect in the statement of the Society's financial position.

55. The material I have recovered indicates that there has been widespread dissatisfaction with the Society's selling and administration practices. Some of it extended over time. Some related to relatively recent events and was specific to the situation that arose following the House of Lords' decision. Policyholders' circumstances varied widely, and their responses to the situation varied similarly. Some of the complaints refer to issues that were compromised by the scheme of arrangement. Thus one policyholder who transferred funds from another life office in September 1998 complained about written advice he had received that:

> "With regard to the guaranteed annuities payments, the with-profits fund will not be affected by any guarantees offered to policyholders with these types of contract."

While I can readily understand the frustration of such an individual, the approval of the compromise scheme had precisely the effect it was intended to have in his case,

and extinguished his claim, subject to any common law case he might have based on false representation.

56. At one end of the spectrum of relevant complaints, there were knowledgeable and careful individuals who have complained that they were misled by specific representations. One 'late joiner' had been a Standard Life policyholder who, at his sixtieth birthday, continued in self-employed work and wanted a flexible pension arrangement. He decided that he wanted an income draw-down scheme. He explored the market. The Society offered a proposal that seemed technically to meet his requirements. The final, detailed discussions took place at a meeting before signature of the transfer documents on 19 July 2000. The Society's representative seemed to expect that the House of Lords would uphold the Society's appeal. Even if the Society failed, the client was told that they had put aside funds to cover any shortfall. Because the money had been put aside new investors would not be affected. He wrote:

> "Because I expected a fall in the stock market I was recommended to place my funds in the with-profits scheme as a means of protecting my investment."

His 'Reasons Why' letter indeed stated:

> "... your personal view is that world markets are currently overvalued and likely to suffer downward correction, so for the time being capital security is a priority.
>
> As an investment link for your Managed Pension I recommend that you invest 100% in the Society's with-profits fund, which balances the degree of risk with the potential reward that you agreed was acceptable..."

The transfer took place early in August. On 9 August, he was asked to sign a 'Declaration for all new proposals on and from 20 July 2000' which removed any entitlement to a windfall payment arising from the sale process. He took this as a hopeful sign. On 16 July 2001, with little if any accrued bonus, he suffered a 16% cut in the value of his fund. Other events followed.

57. It is not for me to adjudicate on the policyholder's complaint that he suffered from 'corporate mis-representation'. But the case illustrates one category of complaint: the individual who claimed to have been exposed to risk by continued selling after the House of Lords' decision without adequate protection, who was asked to discharge benefits that might in other circumstances have been expected to flow from participation in the with-profits fund, and who was nevertheless fully exposed to the risks of participation in that fund. This policyholder did not claim to have been misled about income draw-down products generally, and was clearly prepared to accept the risks of market volatility. His complaint was that he had been misled about the Society's financial position and its ability to provide the benefits he understood he was purchasing.

58. Others complained in more simple terms about the advice given that the Society's with-profits fund was the safest haven for their savings. A particular complaint about misinformation related to business written after the change in 1998 of the specification of the Society's RSP with-profits contracts to exclude reversionary bonuses. Policyholders have complained that they were given no or inadequate information about the implications of the new form. The impact of the cut in policy values on a managed pension plan written in 1998 was a reduction that affected primarily the guaranteed benefits under the policy. Policyholders complained that they had received no or inadequate information about the risks associated with having all prospective bonuses in non-guaranteed form.

59. Others complained about the information given at maturity. A sixty-seven year old annuity guarantee policyholder was considering taking his pension early in 2001. Concerned about rumours that non-guaranteed bonuses might be removed, he consulted his Equitable adviser about accelerating the pension date. He was told that it could not happen: Equitable would lose all credibility if they cut values. He

accepted the advice and delayed taking pension. He suffered the 16% cut in July and his pension was reduced. He was critical of the Society for giving misleading advice, and of the regulator "who should have been policing the situation".

60. Some have complained about the impact on their investment as continuing members of the with-profits fund of over-distribution on others' claims. Thus one policyholder wrote that following the House of Lords' decision the Society's Board did not take adequate steps to protect policyholders by allowing transfers out of the fund and benefit payouts to be at a higher rate than was a fair share of the fund to those policyholders. This, the letter stated, was accepted by Equitable and had been shown to be true by the increasing transfer penalties and reduction in fund values that the Society had had to impose.

61. It would be inappropriate to summarise the whole correspondence received. These examples illustrate a wide-ranging problem associated with policyholder discontent focused on the Society's products, marketing and sales processes, and the management of its distribution policies. The attitudes towards the Society that the correspondence displays are in no small part a reaction to discovery that the myths the Equitable spread about its unique and highly superior ethos were not soundly based in fact.

62. In October 2003, the Society intimated an offer of compensation to policyholders who bought with-profits policies between 1993 and 1998 following publication during the summer of 2003 of adjudications of the Financial Ombudsman Service on a series of lead cases. The working out of this process may resolve some of the outstanding issues between the Society and its policyholders and former policyholders. The offer implies acceptance of a level of liability. The result will inevitably be a further re-distribution of value within the with-profits fund. Revision of the approach to the rectification scheme policyholders is in progress. This also may resolve issues. But as the Warren Moss and Glick opinions indicate there may remain scope for a wide range of claims based on the particular circumstances of individual policyholders. Late joiners generally and the purchasers of with-profits annuities are likely to continue to press claims. Until the outstanding claims are resolved, there is bound to be continuing concern about the financial position of the with-profits fund at 31 August 2001 and later.

63. An inquiry such as this cannot achieve the results the policyholder hoped for: no inquisitorial process could. But there is one lesson that should not be forgotten in the future. When a major system fails, be it a failure of governance or regulation, the impact tends to fall on vulnerable individuals who are likely to be disturbed by the experience. In a case such as this, damage is done not only to policyholders' financial resources, but to their self-esteem and their confidence in their ability to manage their affairs. Maintaining confidence in the financial sector as a whole is important. But it should not be achieved be at the expense of those who cannot help themselves.

PART IV: GOVERNANCE AND AUDIT

CHAPTER 9: CORPORATE GOVERNANCE

1. The chapters on lifting the veil and on reporting obligations have aimed at explaining Equitable's realistic financial position in comparison with its published position and at explaining how its accounts were prepared and published without disclosing factors material to an objective assessment of the Society's state of affairs. In particular, I have sought to identify the excess allocation of bonus to policyholders over available assets that contributed to the need to reduce policy values in July 2001, and pointed to residual weaknesses in the Society's financial position. In this chapter I shall explore the background further to expose the managerial structures and policies that allowed the position to develop.

2. In looking at the governance of the Society, there are some issues to be borne in mind. The Society has at all material times been an unlimited liability mutual company. As a mutual, its with-profits policy values are a function of its assets less prior creditors' claims. Unless its assets were to fall below the level of its un-subordinated liabilities to third party creditors, that is creditors other than as with-profits policyholders of the Society or creditors subordinated to with-profits policyholders, it could not become insolvent in any absolute sense. The risk of the Society trading while insolvent in these circumstances was remote. The directors at all times had the right to cut policy values in the with-profits fund to reduce the aggregate liabilities of the Society to the level of its available assets. The timing of such a step would have been critical to policyholders as a whole and individually. The Society could have become technically insolvent in a regulatory sense well before it reached a state of absolute insolvency, and that would have been the more likely occasion of external intervention in its affairs. Regulation of the Society is discussed later. But for the present it is the internal management of the Society's financial affairs that must be the focus of attention.

3. It is also important to bear in mind the risk that concentration on the Society's global financial position may divert, and in the past might well have diverted, attention from the impact of management decisions on groups of policyholders and on individual policyholders at the point of investment and on claims. An overview of the business must not ignore the consequences for those directly affected. Equally, concentration on one cohort of policyholders, for example those whose policies were about to mature, to the exclusion of those who might be expected to remain participants in the funds over a longer term, could also affect adversely the fairness of the decisions reached..

4. The implications for policyholders can be illustrated by reference to the case of a retirement annuity or personal pension policyholder approaching maturity. Until the policyholder reached pension age, he would have remained a with-profits policyholder and a member of the Society. His policy value would have been vulnerable to any cut announced by the directors. On the day he reached pension age, had he taken no fresh initiative, his benefits would have crystallised, and become a fixed liability of the Society. Prima facie the policyholder would immediately be protected, by the emerging contractual liability, from vulnerability to cuts in total policy values. But the policyholder would have been confronted by choice. He might exercise the open-market option and take his benefits elsewhere, divorcing his future financial interests from those of the Society. He might take his contractual rights. The annuity would begin to run, wholly or substantially backed by fixed interest securities. He might exercise the commutation option, and otherwise take the annuity secured by the contract. He might elect to transfer into a with-profits annuity and become again vulnerable to policy cuts. He might exercise any of the alternative benefits options specified in the contract. The directors' decisions could not properly be focused on an analysis of the fund that failed to take

account of the multi-faceted nature of the policyholder's problem in dealing with a complex product.

5. The Board of Equitable would have owed duties to the particular policyholder, to all those already in pension before him, and to the body of continuing policyholders who remained in the with-profits fund at his departure, as well as those who might join thereafter. Those duties would have been expressed in part in the Board's duties in the exercise of powers under the articles of association to determine the levels of bonus payable to policyholders generally, the maturing policyholder in particular, and the body of continuing policyholders whose interests would be affected by actions taken relative to the benefits of the departing member. The arrangements made for the due recognition and performance of the Board's duties in these areas are topics of importance in the present discussion. These would not exhaust the overall responsibilities of the Board. The effectiveness of governance has to be considered in a wide context.

6. This chapter is concerned with the arrangements in place for governance of Equitable over the period of the inquiry's interest in respect of the recognition and quantification of policyholders' rights. Some issues may have a wider relevance, for example the problems associated with unlimited liability mutual assurance companies carrying on long-term business. But essentially the discussion is focused on the Society, and in particular on the delegation of areas of responsibility to the Society's actuary and actuarial staff. There are current proceedings in the High Court between the Society and some of its former directors and auditors. It is not for the inquiry to offer views on any allegation of breach of duty that has arisen, or may yet arise, in civil proceedings. But it would be impossible to provide a complete account of the financial history of the Society without discussing the respective roles of management and the Board over time in relation to policyholders' rights and the Society's corresponding liabilities. Whether the circumstances narrated might support a conclusion of breach of duty, or provide exoneration from any such breach must be left to others.

Applying general principles

7. The Cadbury definition of corporate governance[1] provides a convenient starting point for the discussion:

> "Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

A statement generally to the same effect could have been made at any time during the period of interest. However, it is immediately apparent that the definition, adequate where the entity's shareholders and customers are not identified with each other, does not capture the relationships peculiar to a mutual life company, and in particular the fact that, in the case of mutual with-profits business, the persons with whom business is done are the persons for whom business is done.

8. Cadbury reported against a background of developing law both in relation to the collegiate responsibility of boards and in relation to the individual responsibility of directors. In relation to individual responsibility changes were more far-reaching. In *Bishopgate Investment Management Ltd* v *Maxwell (No 2)*, Hoffmann LJ said:

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[1] The Financial Aspects of Corporate Governance (the 'Cadbury Report'), paragraph 2.5.

> "In the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance ..."[2]

The standards demanded of directors individually at the end of the twentieth century and beginning of this century cannot be applied uncritically to earlier periods. It would be particularly inappropriate to apply current and emerging standards in judging the conduct described in this chapter of the report. But it is legitimate to use those standards to explore the lessons to be learned for the future from the events of the past.

9. Fixing bonus levels for with-profits policyholders was a central element of the range of duties imposed by the articles of association of the Society on the directors. It is clear that balancing the interests of successive generations of policyholders of the same class, and balancing interests among the classes at any time and over time, imposed obligations on the Board as a whole, and on the directors individually. The members were all policyholders of the Society, but the reverse did not hold true: certain policyholders might never be members, and some might relinquish the status of member while the contract that sustained membership subsisted. The directors' obligations were wide-ranging.

10. General comments on corporate governance would be beyond the scope of this report. The Cadbury Report, Hampel's Principles, the Combined Code of May 2000, and the Greenbury recommendations on remuneration were taken into account by Equitable, though they were applicable strictly to listed companies, and some reference to these materials will be unavoidable. But it would be inappropriate to comment more generally. The comprehensive studies of the Law Commission of England and Wales and the Law Commission of Scotland[3], the report of the Company Law Review[4], and the white paper Modernising Company Law[5] set out the nature and extent of directors' duties and responsibilities as developed in the common law and current legislation, the analysis of present thought, and proposals for future developments in legislation and self-regulation. These have been followed by the Higgs[6] and Smith[7] reports among other developments in thought and practice.

11. Within this body of work, the position of unlimited liability mutual societies has not received in-depth treatment. However, among the dwindling number of surviving mutuals are companies of major economic significance in the financial sector, handling the public's savings, and in particular savings for their future pensions. By definition, mutuals have no shareholders. The nearest equivalent interests are those of with-profits policyholders or some class or classes of those policyholders. In the case of Equitable, as I will discuss below, the relevant classes of policyholders had no material role in governance

12. Underlying the provisions proposed in the Company Law Review is a structure in which one can identify members' interests, customers' interests, suppliers' interests and society's interests, and contemplate the extent to which it is possible to achieve a balance among them. In the case of a mutual life assurance society interests falling into each of the categories can be identified. The external physical and economic environment in which the office operates will not differ significantly from that of any proprietary office. The office will have relationships with suppliers of goods and services required for the conduct of the business. There will inevitably be

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[2] 1993 BCLC 1282 at page 1285.

[3] Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties: Consultation Paper 153, Report 173.

[4] Modern Company Law for a Competitive Economy: Final Report of the Company Law Review.

[5] Modernising Company Law, Cmnd 5553.

[6] Review of the Role and Effectiveness of Non-Executive Directors, Derek Higgs.

[7] Audit Committees: Combined Code Guidance, Robert Smith.

an interest in the office's reputation: sales depend on confidence. Fair outcomes as between members are inseparable from the business objectives of a life office.

13. But the relationship between the members and the company is unique. A basic characteristic of mutual business is the identification of membership of the company with the contractual relationship between the holders of participating contacts and the office already mentioned. Membership is typically defined in terms of participation in the profits or distributable surplus of the office. Non-participating contracts, for example a fully guaranteed policy providing a fixed obligation to pay a specified sum of money on a contingency, and linked contracts may not qualify the policyholder for membership. Policyholders may be members or may be creditors of the company or both, with those relationships arising from their policies and defined in the constituent documents of the office by reference to those policies. This makes the application of common rules and principles of governance difficult.

Formal structures

Policyholder Role in Governance

14. Subject to limited qualifications, Equitable's articles defined a member as a person who had effected a policy that at the material time entitled that person to participate in the profits of the Society. The holder of a non-profit policy did not qualify for membership, nor did the holder of a unit-linked policy. The proportion of the total range of policyholders that qualified for membership at any one time would depend on the classes of business that had been sold and remained in force at the time. The qualifying class would of necessity be the members of a fluctuating group of policyholders identified primarily by the terms of their contracts with the Society, for the time being, and only secondarily in terms of the constituent documents of the Society. They would enter the class, qualify for membership rights, see those rights change with time, and ultimately leave the class, their position throughout determined in terms related to investment of contributions, accrual of benefits, and maturity or surrender of benefits under their contracts with the Society.

15. Thus their status could change while they remained in contractual relationships with the Society controlled by the sale contract. For example, a contract for a deferred annuity might participate in profits until maturity when it would provide for payment of an agreed or calculated annual sum until death. At that point the policyholder would cease to enjoy the benefits of membership. There would, in that case, be a material change in the economic relationship between the policyholder and the office under the same contract. Ignoring insolvency, crystallisation of benefits would insulate the policyholder from future fluctuations in the office's performance and profitability. But differences between policyholders qualifying for membership rights, or full rights, and those failing to qualify might be less clearly based on economic rights. For example, voting rights were limited to members with £1000 of sum assured.

16. The Society, by definition, had no share capital. The aggregate of members' particular qualifying rights constantly changed, and was known only to the Society at any given time. The ability of the members of Equitable to influence the conduct of business of the Society was therefore limited. With the exception of the ordinary recurrent business of the annual general meeting, all business was treated as special or extraordinary, requiring special notice and, typically, an extraordinary general meeting of the Society[8]. The prospects of any member or group of members obtaining the information necessary to assess whether or not a competent requisition could be framed and deposited were so remote that one can dismiss them as of no practical significance. In contrast to the register of members of a company limited by shares, where one might reasonably expect to find more or less accurate data on membership and shareholding, the policyholders' master file of a

[8] See articles 8 and 24, and section 368 of the Companies Act 1985.

life office is not accessible to members, and, even if it were, in modern circumstances it would require sophisticated software to interrogate the computer on which it was held and extract relevant data. Without access to such data a requisition could not be proposed except on a speculative basis. If a pressure group sought information from like-minded members to support a requisition, it could never ascertain from its resources how the participants' voting rights related to the aggregate voting rights of other members at any one time.

17. For all practical purposes, the scope for raising special business at an extraordinary general meeting of the company depended on the initiative of directors. Members could propose and vote on the appointment of directors. There is no evidence that that right could be exercised effectively, other than in support of the proposals of the directors. But members could have no practical say in the management of the Society's business.

Directors' Role in Governance

18. Management of the business was committed to the directors, subject to certain prescriptive functions reserved to the Actuary. The principal provisions were widely drawn in the articles[9]. The directors had wide powers of delegation to the Actuary of the Society and to committees of the Board, and, in the case of duties imposed on or entrusted to the Actuary by the Articles, to others[10]. Delegation to the Actuary of powers exercisable by the Board might be subject to conditions, and was liable to revocation, withdrawal or variation by the Board. There were similar powers to revoke any delegation of power to a committee. In terms of statute, the appointed actuary of the Society, who might or might not be the Actuary appointed in terms of the articles, had independent responsibilities to regulators and relative rights that were not amenable to the directors' control. But all the powers of the Actuary derived from the Board were subject to revocation, withdrawal, alteration and variation. Delegation did not relieve the Board of its responsibilities. The provisions for revocation and variation in particular required active monitoring of the exercise of delegated powers if the Board were properly to manage the business.

19. Such wide powers of delegation raise important issues for the future. In their joint report, the Law Commissions concluded that there should not be a statutory provision setting out the circumstances in which a director might delegate his powers to others and rely on information provided by others without incurring liability[11]. The report recognised that a director might delegate matters to an employee of the company where the articles of association permitted it, and the needs of the business required it, in the absence of grounds for suspicion; and that a director might need to rely on information provided by employees and others[12]. This would be particularly relevant in a life office where actuarial judgment and advice would inevitably be required to inform directors' decisions. But the report stated:

> "The courts in this country have ... recently had to consider the responsibility of a director who delegates. In *Re Barings plc* Sir Richard Scott VC confirmed that the overall responsibility of a director is not delegable. He said that the degree of personal blameworthiness that may attach to the individual with the overall responsibility, on account of a failure by those to whom he has delegated, must depend on the facts of each particular case. For example it might be that personal responsibility would attach because the system in which the failure occurred was inadequate. Similarly, in *Re Westmid Packing Services Ltd* Lord Woolf MR said that each individual director owed duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. A proper degree of delegation

[9] Articles 54 and 55.
[10] Articles 46, 47, 58(1) and (4).
[11] Law Commissions Report 173: paragraph 5.37.
[12] Law Commissions Report 173: paragraph 5.30, footnote 37.

and division of responsibility was of course permissible, and often necessary, but not total abrogation of responsibility."

The common law is developing to react to the changing demands of society and it was said that matters could be left to the courts. Against this background it is important to look at what happened at Equitable and to consider whether there are lessons to be learned for the future.

Composition of the Board

20. Until 1967 the Board of Equitable Life excluded current executives of the Society, including 'the Actuary and Manager', from appointment as director. When Henry Tappenden retired from office as Actuary and Manager he was appointed executive director, and retained some executive duties. This marked the first departure from established practice. In the following year Tappenden retired from all executive duties, but executive representation on the board was firmly established with the appointment of Maurice Ogborn, Tappenden's successor as Actuary, to the Board in 1969.

21. From that time, executives came increasingly to take part in the direction of the Society. But it was to be some time before that was reflected in any fundamental change in attitude. Peter Martin, an experienced solicitor who was to become vice-president in time, told the inquiry that when he joined the Board at the beginning of 1984 it was his impression that the Society was governed very much by an old-fashioned "gentlemen and players" culture in the form that it had been since it was constituted in 1762 (the period was somewhat exaggerated). The Board consisted of City professionals with no specific life assurance expertise (mainly bankers and stockbrokers) who invested the premiums. There was little connection culturally between them and those executives who were based in Aylesbury. I accept his assessment as reliable. The role of the Aylesbury office was wide, and included management of the sales force, product design and administration, and the actuarial valuation of the liabilities and provisions that quantified the long-term fund and, by comparison with the assets of the Society, the surplus available for distribution.

22. Tappenden was one of two directors who retired from the board at the AGM in1972. They were replaced by Barry Sherlock and the investment manager, Anthony Passmore. With Ogborn's retirement in October that year, Sherlock was appointed general manager and actuary, and Roy Ranson became deputy actuary. There was a further major change in board membership in 1976, with three new appointments, each of whom was to play a significant part in the Society's affairs, Professor Roland Smith, Alan Tritton, both non-executive directors, and Ken Wills, who was the marketing manager. Through the late 1970s and early 1980s, there were generally three executive directors in a board of ten or eleven.

23. In the president's report presented at the annual general meeting in 1982, it was reported that Ranson had been appointed joint actuary (with Sherlock), and, with effect from 1 January that year, appointed actuary in succession to Sherlock. Ranson was appointed a director on 1 January 1985, following Passmore's retirement in 1984. Wills retired in 1986. Thus the report and accounts for 1986 presented at the annual general meeting in 1987 reported nine directors, of who two held executive office, the joint actuaries Sherlock and Ranson.

24. On 1 January 1989 three new executive directors were appointed: Roger Bowley (company secretary), Shaun Kinnis (marketing director) and David Thomas (investment director). Of the twelve directors at the annual general meeting in 1989, five held executive office. At what was to prove the beginning of a critical period in the Society's history, the balance of influence on the board had changed: though still a minority, the executive directors now constituted a significant force on the board. The Society's business was evolving at the time into the modern form that was to continue throughout the remainder of my reference period.

25. By the time these appointments were made, it was Martin's impression that the character of the Board had changed. There was movement towards creating a

modern Board that operated as a single cohesive body. The "gentleman and players" culture was breaking down. Non-executive directors were drawn from a wider background, and there were efforts to bridge the cultural divide. According to Martin, the Board began to be more cohesive with the appointment of Roland Smith as president in 1986. Smith, who has since died, apparently acknowledged limitations in his understanding of the financial side of the life business, but was keen to understand better how it worked in business terms, and on his initiative the Board gradually began to get much better information. They began to see more clearly how the Society was operating month by month. Again I accept Martin's assessment as reliable. It is not immaterial that it was only in and after 1986 that the Board began to get management information of the kind Smith required. However, the Aylesbury factor continued to make an impact. The Board received additional information about the current management of the Society. But it remained dependent on the actuaries for technical management, and in particular for the critical elements of product development and liability valuation.

26. At the annual general meeting in 1994 three directors retired: Professor Sir Roland Smith, Sir Christopher Wates and Barry Sherlock. John Sclater was appointed president. At the annual general meeting in 1995, Sclater had a board of thirteen, of whom five held executive office (Alan Nash having been appointed in April 1993). However, there was a further significant change to the composition of the board in 1997, with the retirement of Ranson and Kinnis (both 31 July 1997) and Bowley (retired on 31 December 1997, but retained executive office). Two senior executives at the level below the Board also retired at this time, and the inquiry has seen some evidence that this transition was a fractious affair. At the annual general meeting in 1998 the Board had reduced to eleven members of whom two were executives: Nash and Thomas. That remained the position at the following year.

27. Over a critical period at the end of the 1980s and into the 1990s there was a strong executive presence on the Board. Until 1997-98, and the reduction in executive directors under Sclater's presidency, executive influence on the Board had grown from insignificant until, especially under Sir Roland Smith, it had become a material force, stabilising at about five out of a fluctuating total of around thirteen to fourteen directors.

Committee structure

28. Over time, the Board established committees, some of relatively short duration and some longer term or even permanent. There was a new business committee in the 1970s when achieving growth was a primary concern of the Board. There was a long-standing investment committee. There was a nominations committee. Later there was a remuneration committee. In and after 1994 there was an audit committee. But a substantial part of the actual business of the Society was delegated to the executive.

29. The actuarial department had substantial control of product design, and, critically, liability valuation and related matters. The actuarial department was intimately involved in investment policy formulation. Marketing was effectively delegated to the marketing director and his staff, subject to report. The actuary of the Society appointed in terms of the articles of association was not necessarily leader of the Aylesbury actuarial department. Ogborn appears to have controlled the actuarial function and operated as chief executive. Sherlock progressively delegated the actuarial function to Ranson, concentrating in the London office on general management issues. By the end of the 1970s and early 1980s Ranson had become the single most powerful executive of the Society. He became appointed actuary in 1982, and his position was consolidated when he became a director in 1985. He held jointly the offices of managing director and appointed actuary between 1 July 1991 and 31 July 1997. But his influence and authority were established long before that time.

30. From the discussion of the developing bonus policies of the Board from the early 1980s onwards[13], it appears clearly that the Board's dependence on actuarial advice was total. None of the non-executive directors had relevant life office experience, or relevant qualifications. The heavy concentration on investment matters reflected the interests and expertise of the majority of the non-executive directors. They were not equipped to challenge actuarial advice, and it appears that they were advised and accepted that that was not their role. In practice the actuary provided the board with a great deal of written material and oral explanations of the management of the business and of the decisions that had been taken. The Board asked questions and received explanations. But, critically, there were few decisions. In relation to valuation, the quantification of surplus, and the allocation of bonuses generally, the Board was almost totally dependent on the actuary for information and for advice. It was in relation to this area that delegation was seen to operate most comprehensively and to remain unquestioned.

The Appointed Actuary

31. On 24 August 1977, the Board was presented with materials relating to the appointed actuary's role. The minutes record receipt of a letter from the Department of Trade stressing the need for the appointed actuary to be provided with sufficient information on a continuing basis to discharge his responsibilities and reminding offices that it would be a matter of concern to the department if it appeared that decisions of significance to the interest of life policyholders had been taken and implemented without the appointed actuary being given an opportunity of commenting, or if the decisions were contrary to his advice. The letter enclosed the terms of a reply to a question in Parliament and the Institute of Actuaries guidance note for appointed actuaries. It communicated effectively the intention of regulators at that time that the appointed actuary should have a central role in the formulation of policy.

32. The statement in Parliament had underlined the need for the appointed actuary to have continuous access to relevant information, and lent authority to the professional guidance note. But the professional guidance did not remove from the board of directors of life offices the responsibility they had for the conduct of business: rather it underlined and supplemented those responsibilities. It stated that responsibility for company decisions must, in law and in practice, rest with the board of directors. But the emphasis placed on these statements by the Equitable Board tended to convey the impression that the appointed actuary in particular had a predominant role as a director in relation to matters that fell within the area of his responsibilities as appointed actuary, though that was not consistent with the tenor of the note. In reporting to the Board, the appointed actuary drew attention to his position as such in making recommendations and tendering advice.

33. The guidance, correctly in my view, emphasised the role and responsibility of the board of directors of life companies, and the role and responsibilities of the appointed actuary in that context. Where the appointed actuary was a director of the company, he had all of the obligations to the company and to co-directors that any director with special qualifications would have. The statutory responsibilities were additional to that.

34. The duties of the appointed actuary were spelled out in the professional guidance note. It was said to be incumbent on all appointed actuaries to ensure, so far as was within their authority, that long-term business was operated on sound financial lines. It observed that every actuary acting in his professional capacity had a duty to his profession. The appointed actuary was said to be in a special position in that he was appointed and remunerated by the company, and at the same time had responsibilities and obligations to the Department of Trade by reason of his statutory duties, which arose from the department's supervisory functions aimed at the protection of policyholders. In relation to the company, the appointed actuary

[13] See Part II to this Report.

had duties to give advice in relation to his statutory duties. Within the scope of those duties, the appointed actuary was privileged. Paragraph 8.3 of the guidance note stated:

> "A special responsibility is owed to the appointed actuary by any other actuary who is a director. He can be of great use both to the board and to the appointed actuary, in assisting the board to a full understanding of actuarial issues. He should be careful not to act in such a way as to diminish the status of the appointed actuary."

35. The official statements were concerned to ensure, so far as encouragement could achieve it, that boards of directors and chief executives provided the appointed actuary with the information required to assess the on-going financial health of the office, to understand the terms and conditions applying to new contracts, to understand the investment policies of the office, and to understand its marketing strategies. In the case of Equitable these matters were largely either the business of 'the Actuary', who was not necessarily the appointed actuary, or materially influenced by him. At all material times Ranson had de facto executive control of the relevant areas of business.

36. The official statements were general in scope, and were intended for companies with a wide range of governance arrangements in which the person for the time being holding office as appointed actuary might, at one extreme be chief executive and at the other a technical officer who was not a director. They had more relevance to companies in which the appointed actuary did not have direct control of the sources, or most of the sources, of relevant information. Sherlock was at the time general manager and actuary in terms of the articles, and appointed actuary in terms of the statute. Ranson had control of the actuarial function at Aylesbury, and in 1982 succeeded to the position of appointed actuary. When the 1982 Act came into force, he was also reporting actuary for Companies Act accounts purposes. The Society was far from the model assumed in these original forms of guidance. But reliance on the official statement, and on the joint professional bodies' statement, served to emphasise the predominant position of the actuaries in relation to the areas of responsibility they had.

37. Successive editions of GN1 and GN8 modified and developed the guidance as originally set out in these documents. However, for present purposes it is sufficient to note the underlying assumptions as to the relationship between the appointed actuary and the board that they reflected.

38. The paper *With Profits Without Mystery*[14] described the role of the actuaries of the Society as follows:

> 4.4.1 It will be evident ... that for the successful application of a concept such as the with-profits managed fund, there needs to be a high level of actuarial involvement across all aspects of the business. It is, perhaps, not surprising that the concept has developed in our office which has a long tradition of strong actuarial control running back to William Morgan. That control is not applied in a limited technical way but in an outward-looking positive manner designed to foster the commercial success of the organization. We believe that actuaries have unique insights into the operation of life offices which make it vital they should play a central part in running those institutions. Recent proposals to strengthen the position of actuaries in organizations where their role has been less central are therefore to be welcomed, but there is, perhaps, scope to develop actuarial attitudes so that offices see the gains to be obtained in involving actuaries fully in their businesses. We fully agree with Redington's well-known comment that "an actuary who is only an actuary is not an actuary."

[14] See chapter 4.

The Society's published position on corporate governance

39. The directors' report in the report and accounts for 1994 contained a statement on corporate governance. In it the directors acknowledged their responsibility for establishing and monitoring the effectiveness of the system of internal control used in the Society and the Group, the objectives of which were said to be to provide reasonable assurance of effective and efficient business operations; the safeguarding of assets; control of transactions; the maintenance of proper records and the reliability of financial information used within the business or for publication; and compliance with laws and regulations. It stated that in assessing what constituted reasonable assurance the directors had regard to the materiality of any financial risks incurred, the likelihood of such risks crystallising and the cost of and benefits from particular aspects of the internal control system.

40. In relation to the accounts, it was acknowledged that it was for the directors to select and apply suitable accounting policies; make reasonable and prudent judgments and estimates; state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts; and to prepare the accounts on the going concern basis unless it is inappropriate to presume that the Group would continue in business.

41. A more extensive statement appeared the following year, 1995. It stated that the Board considered that the Society met in all material respects the spirit and approach of the Cadbury code of best practice. In substance it made the same representations about the scope of the directors' responsibilities as the 1994 statement. It gave full details of the committee structure.

42. In 1996 the president's statement to members on corporate governance was relatively brief. But the Board pinned its colours firmly to the mast in the directors' report and represented to members and the public at large that its procedures complied with the current codes of conduct in all material respects. There was an extended statement of the position in the directors' report in the annual accounts. The statement defined the role of the audit committee strictly in terms of the Board's responsibilities for the accounts and for the accounting policies of the Society, the contents of annual reports and accounts, the conclusions drawn from internal control reports and the adequacy and scope of the audit. Internal control was the ultimate responsibility of the directors, and extended to establishing and monitoring that the Society had in place an appropriate system of controls, financial and otherwise, to provide reasonable assurance with respect to:

- the business being operated efficiently and effectively;
- the safeguarding of assets against unauthorised use or disposition;
- the maintenance of proper records and the reliability of financial information used within the business or for publication;
- compliance with laws and regulations.

It was stated that in assessing what constituted reasonable assurance, the directors had regard to the materiality of any financial risks incurred, the likelihood of such risks crystallising, and the cost of, and benefits from particular aspects of the internal control system. The effectiveness of the system of control was said to be reviewed regularly by the Board.

43. The presentation changed in the 1997 accounts, but in substance the message was the same. In the 1998 account the president's statement and the directors' report stated that the Society was committed to integrity and professionalism in all its activities, and that as an essential part of this commitment the Board pursued the highest standards in corporate governance. They confirmed that the Society had voluntarily adopted the Combined Code appended to the listing rules of the London Stock Exchange. Limited exceptions from compliance were noted. The scope of the audit committee's remit as published remained the same as previously published, as did the directors' responsibility for internal control.

44. In the 1999 Accounts, the Society's adherence to the Combined Code was repeated. The scope of the audit committee's remit was altered to include risk management and internal controls. The directors' report restated the directors' position on accountability and audit. It repeated the statement of the directors' responsibility for internal control for the Society and the Group, and made comments on the requirements and limitations of a sound system of internal control. It acknowledged the directors' responsibility, in terms of the Combined Code, to review the effectiveness of the Society's and the Group's system of internal control, including financial, operational, compliance and risk management controls. It set out the steps taken during the year to review the effectiveness of the existing system, and outlined the main elements of the Society's control framework. These included:

- A report on the results of the annual valuation by the appointed actuary.
- A risk management group (RMG), which assisted the Board in identifying, managing and controlling risk.
- Regular review of significant control issues by the Audit committee, which received reports from management and from the RMG as well as from the Society's external auditors.
- An annual risks and controls self-assessment undertaken by management, the results of which were considered by the RMG and the audit committee.

The position reflected material developments. The 2000 accounts reflected a similar position, though now having closed to new business, the report took account of that reality.

45. The developments presented in the Society's published financial statements reflected the response to external developments in the recognised requirements of good corporate governance, and processes of development and change within the Society. As earlier discussion has shown, the Board's understanding of the annuity guarantee issue was at best limited until the autumn of 1997, and some directors may not have had any understanding of the position. The guarantee issue was an aspect of liability valuation. It is primarily in that context of liability valuation that one must consider the internal developments and seek answers to the questions that arise from the apparent failure of the Board to identify and to react to the risks confronting the Society as a result of its valuation and distribution policies.

Management of Risk

46. Risk management, in the most general terms, began to emerge as a significant issue in the early 1990s, initially on a limited basis. In 1992 the auditors advised that, with the Society's growth and the ever-increasing size and complexity of its operations, there was an increasing risk of error or fraud remaining undetected. They proposed an independent systems and controls review or internal audit function as possible solutions. They said that they understood that the Society might be considering an independent systems and controls review function and commended that course.

47. In response, in a paper dated 23 September 1992, Ranson wrote:

> "The Society is currently considering how to achieve the general objective of ensuring compliance with agreed operating standards. Endorsing this objective and noting actions taken to date, the auditors recommended the formation of a system and controls review function. We are considering this recommendation whilst remaining committed to achieving our objective without materially increasing costs or diminishing the accountability or responsibility of local managers."

A management group was envisaged rather than a committee of the Board.

48. The new unit was set up. The terms of reference were approved by Ranson on 8 February 1993. The unit was to operate strictly within the current management

control system. On 10 February 1993 Ranson issued a memo entitled 'Systems and Controls Review', which said that the unit was to cover all aspects of the Society's UK operation, except those areas covered by the compliance officer. Members of the unit were to have access to whatever information or explanation they considered necessary to fulfil their responsibility, including access to any record, personnel or physical property of the Society (although certain information might be restricted to the unit's manager only).

49. In comments to the other senior executives, Ranson treated this as a personal project. The terms of reference for the unit were circulated to senior executives on 17 February. They were:

> "Role and Purpose of the Systems and Controls Review Unit
>
> Systems and Controls Review is an independent appraisal function, established within the Society, to monitor the operation and effectiveness of systems and control procedures, pointing out, wherever possible, those that appear inadequate.
>
> Primary Purpose
>
> To make the Society more effective and cost efficient by way of: providing a service to all levels of the Society's Management in relation to ensuring compliance of the various parts of the organisation to:
>
> a) Society policies, as laid down by the Board of Directors;
>
> b) Internal procedures, methods and standards set by Senior Management;
>
> Secondary Purpose
>
> To assist all levels of the Society's Management by way of: pointing out procedures, methods and standards which appear inadequate for the purpose, assessing risks and recommending possible courses of action."

The terms of reference were to be reviewed annually to confirm that the document continued to be accurate and up-to-date. There is some evidence that the unit was an answer to pressure from some directors for an internal audit system that Ranson did not want.

50. The unit was given wide authority:

> "In carrying out its duties and responsibilities the Review Unit has full and unrestricted access to all the Society's U.K. activities, records, property and personnel, (except that its scope does not encompass Compliance matters)."

The objective of the unit was to ensure compliance with the Society's internal systems. Responsibility for the unit's operation was placed firmly with the general management team (GMT), a team of the Society's most senior executives. A strategy document for the unit listed a number of possible areas for review in 1993. These included "all aspects" of reassurance and "determining amount due, and the paying of – annuities, maturities, surrenders and underwriting (all aspects)". The remit covered generally salaries, purchasing procedures, computer equipment, cars, general office equipment, stationery and printing materials, cash control systems, and other matters.

51. On 26 August 1993 Ranson distributed a further memorandum to general managers and senior managers, taking matters further. He observed that it was for the GMT to decide which risks facing the Society were acceptable and which needed attention. He said that the Society had formulated various basic principles of operation aimed at combating unacceptable risks. But the combination of growth and mechanisation made it timely to address the issue, and the GMT would be reviewing the areas of control where risk was perceived to exist. He identified members of the executive team who would be involved.

52. The auditors' suggestion of an internal audit function had been rejected. The inquiry has been informed that it had been rejected by Ranson. The unit, to become known as the Systems and Controls Review Group or SCRG, had a wider remit than envisaged in the auditors' management letter. But its involvement in the actuarial area of management was limited. It was concerned, for example, with the implementation of benefits payments, not the determination of liabilities or surplus or the allocation of bonus, nor with the risks associated with these factors. The SCRG was not given an internal audit function. Ranson considered that to do so would create expectations as to its activities and place in the organisation that would be not be relevant to its role. Julian Hirst, the Society's chief accountant at the time, told the Inquiry that "The remit was different to that of an internal audit function – its remit was to ensure compliance with office principles and policies and to assist management".

53. The group took up the work and produced substantial reports, for example a report on investment procedures and controls circulated in draft for comment on 1 March 1995. Within the scope of its remit, a great deal of work followed the setting up of the unit in this and other areas in 1994 and 1995. But the limitations on its remit had practical consequences. The group did not assess policy in the context of the Society's general aims. It did not have the role of ensuring that procedures were being complied with: that was the job of managers. It could not follow up issues that might involve risk, since it was not to "provide solutions".

54. Meantime, the Board established an audit committee in January 1994. It met on 26 January 1994. At that date the SCRG was dealing with areas that might otherwise have been seen as the province of the Board's audit committee. The corporate governance statements in the 1994 and 1995 accounts could have given the impression that the SCRG remit was a Board rather than a management function. The Cadbury Report on corporate governance had been published two years earlier. The Society was not a listed company and was not obliged to set up an audit committee, in adherence to the Cadbury rules. However, from witness evidence, it appears the executive came under pressure from the Board to comply with Cadbury. There was a desire on the part of the Board to present the Society as a modern company, conducting its business in line with the latest thinking and decisions on governance. The approach reflected a growing appreciation of the need for the Board to play a more central role in relation to the Society's business as a whole.

55. Hirst told the inquiry that non-executive directors were familiar with governance in the general market place, and that there was pressure to have an audit committee and some sort of audit function. Internally it was felt that, whilst the listing requirements didn't apply, Equitable was a public interest company and went out to demonstrate corporate governance on this basis. He suspected that some executives would have been less happy about the proposal on the grounds that it was thought to undermine management's responsibilities. "It was against the ethos of the Society."

56. The Society's ethos was reflected, typically in my view, in the informal arrangements for contact between the executive management and senior members of the board. According to Hirst, the president and vice presidents were invited by the executive to an annual lunch with the external auditors on completion of the audit in early March. Apart from this, there was direct reporting to the Board on actuarial and related matters without the intervention of any committee.

57. Despite Ranson's apparent reluctance to set up an audit committee, in January 1994 he wrote the instigating and defining document for its existence. The purpose of the document was said to be to "consider the need for and to make recommendations regarding the formation of an Audit Committee to the Board". It reviewed past practice and commented on the "potential pitfalls" as well as the benefits of having an audit committee.

58. The desirability of establishing an audit committee was attributed to the growth of the Society, and the need to provide comfort, through a process of independent and objective review, that financial reporting and control were operating correctly. The comfort was said to be for directors, and particularly non-executive directors, reflecting the provenance of the pressures to set up the committee. However, there was a "fine line between an effective oversight role and the responsibility of management to manage the business" and Ranson warned that an audit committee could not relieve the Board of its collective responsibility for financial reporting and control processes, and:

> "It is also essential that an audit committee should not stand between the auditors and the executive directors or in any way inhibit access by the auditors to the full board."

The answer, he said, was to ensure that the committee was properly constituted.

59. On 26 January 1994 the Board approved terms of reference for the audit committee. The main duties of the committee were set out in Ranson's paper:

"a) To review the Report and Accounts before submission to the Board, with particular regard to:

i. Any changes in accounting policies and practices.

ii. Major judgmental areas.

iii. Significant adjustments resulting from the audit.

iv. The going concern assumption.

v. Compliance with accounting standards.

vi. Compliance with legal requirements.

b) To discuss problems and reservations arising from the audit, and any matters the external auditor may wish to discuss.

c) To review the external auditor's management letter and management's response."

These remained the committee's terms of reference until 1996.

60. Revised terms of reference were adopted on 24 April 1996. The revised format defined the objectives of the committee as ensuring that the financial systems provided accurate and up to date information on the Society and Group financial position and that published statements represented a true and fair reflection of this position; that appropriate accounting policies and internal controls were in place; and that the Society met in all material respects the spirit and approach of the Cadbury and Greenbury Codes. The committee was authorised to investigate any activity within its terms of reference; to seek any information it required from any employee related to any matter within the committee's terms of reference; to obtain any relevant legal or accounting professional advice; and to invite outsiders with relevant experience and expertise to attend meetings if it considered this necessary. The duties, (a), (b) and (c), set out in the 1994 terms of reference were repeated. In addition, the committee's remit extended:

"...

d) To consider, at a high level, other topics likely to be of relevance to the Report and Accounts of the Society.

e) To consider the appointment of the auditors, including terms of engagement, and the audit fee.

f) To discuss with the external auditors before the audit commences the nature and scope of the audit.

g) To review the statutory returns to the Department of Trade and Industry before submission to the Board.

h) To receive reports from the Systems and Controls Review Group, including an annual report on the major reviews undertaken in the previous year and those planned in the future; and to receive reports or specific topics commissioned by the Committee or by the Board for consideration by the Committee.

i) To review the Society's current practices in relation to internal control, calling upon such reports as the Committee shall deem appropriate from management, the Systems and Controls Review Group and the external auditors. Thereafter to review the Society's statement on internal control (to be included in the Report and Accounts) prior to endorsement by the Board."

61. For present purposes, the significant additions, reflecting major changes in approach, and indicating the limitations of the 1994 remit, were (g), the review of the regulatory returns; and (h) and (i) that established a formal relationship between the audit committee and the SCRG, bringing that group's internal control functions into the audit remit.

62. The terms of reference were further extended and amended on 28 June 2000. As appears from the published financial statements, this formulation reflected decisions taken in 1999. The formal paper identified objectives for the committee: to ensure, firstly, that the published financial statements represented a true and fair reflection of the Society's financial position, and, secondly, that appropriate accounting policies and systems of internal control were in place. The committee was authorised, among other things, to investigate any activity within its terms of reference. This extended to the review of reports by management committees covering internal audit, compliance and business risk management and consideration of the cumulative assurance that could be derived on the operational effectiveness of matters related to risk and control.

63. Specifically in relation to risk management and internal control systems, the committee's remit extended to review of:

- the overall framework, policies and processes established by management to embed an effective system of risk management and internal control, covering the nature and extent of the risks facing the Society and the Group;
- the extent and categories of risk which the Board regarded as acceptable for the Society and the Group to bear;
- the likelihood of the risks concerned materialising and the ability of the Society and the Group to reduce the incidence and impact on the business of risks that did materialise;
- the overall culture and attitude towards control established within the Group and relevant aspects of third party service suppliers;
- the business continuity plans and related testing of their maintenance and operation, covering the Society and the Group;
- the timeliness of any corrective action being taken by management to manage risks or to address any shortcomings in internal control;
- the costs of operating controls relative to the benefit thereby obtained in managing the related risks;
- the policies and processes necessary for the Society and the Group to comply with their relevant regulatory and legal requirements, including taxation;
- and, where directed by the Board, other matters such as the Society's and the Group's code of corporate conduct and business ethics.

64. In relation to the regulatory obligations of the Society and the Group, the audit committee's remit extended to the review of reports from management addressing:

- the relationship with the Financial Services Authority (FSA) and other relevant regulatory bodies; the Society's and the Group's compliance with the Financial Services & Markets Act 2000 and related legislation;
- the systems and controls established by management for compliance with the regulatory requirements as specified in the FSA handbook;
- the culture of compliance within the Society and the Group, and other relevant third parties;
- and the Society's and the Group's overall compliance position, having particular regard to FSA's annual regulatory themes.

65. In formal terms, the remit of the audit committee was altered and extended over the period that it existed. The 2000 edition had regard to the position that existed after the acquisition by Halifax of substantial interests in the Society's former business and the administrative arrangements put in place to deal with the residue of the business, the with-profits fund. Leaving aside the specific provisions required to deal with the new regime, significant developments included the review of the overall framework, policies and processes established by management to embed an effective system of risk management and internal control and compliance with regulatory requirements. Risk management in the widest sense had become an aspect of the audit committee's remit. And compliance with the new FSA regulatory regime increased the commitment of the committee to review of regulatory matters. In context, the 1994 committee had a restricted remit, excluding significant areas of management from review.

66. The decisions on establishing an audit committee and developing its duties did not proceed in ignorance of what was happening elsewhere. Hirst explored other offices' risk assessment systems. He obtained copies of the terms of reference of the audit committees at two other life groups from their group accountants . He referred to "the somewhat daunting task of 'managing risk'". He reported to Bowley on his findings to date on 1 February 1996. He reported that Scottish Widows addressed risk management as part of the responsibilities of their audit committee, and that they were in the process of introducing a very structured approach to managing risk. He referred to observations he had made in the autumn of 1995 that the boards of some offices were concerned about the nature and extent of the comfort which they required in relation to internal financial control and, accordingly, had commissioned wide ranging reviews of the control/risk management systems operating in their organisations. Equitable's 1996 review did not take such a radical approach. Not until 2000 was the remit widened to include risk assessment in full.

67. Management structures continued to evolve, and a number of groups came into existence in 1995 and 1996. The minutes of a meeting of one such group, the 'Control of Systems & Procedures Group', on 27 April 1995, disclosed that the SCRG was then reporting to it. It was noted that there did not appear to be a consistent approach to access controls. There did not seem to be a defined office policy. The minute stated:

> "Central guidance on principles needed. Security of the controls is currently in the Management Services area; in other organisations it might more normally be part of the Audit function...
>
> Control should probably be in DCD's area (under guidance from the GMT). Detailed rules would be needed from the central group. Also monitoring would be needed."

The group made proposals for centralised control.

68. Co-ordination of the work of the groups dealing with security risks and controls was discussed in December 1995. Bowley was keen to bring more focus to

the work, and proposed that the 'Control of Systems and Procedures Group' and the 'Risks and Controls Group', which now incorporated the SCRG, should be amalgamated. In a memo from one of the constituents of the Risks and Controls Group supporting the proposal for amalgamation, it was observed that the latter group discussed important issues, but lacked any real structure or formal acceptance of its existence. The writer stressed the need to obtain approval from Ranson because:

> "Without acceptance by RHR of what the group is trying to achieve, and how it plans to operate, an enormous amount of time would be wasted."

The Securities Risks and Controls Group (confusingly the SRCG) was to be set up in response to management's wish to develop internal controls and the risk management framework, and to provide comfort to the audit committee in which Peter Davis (a non executive director and chartered accountant) in particular was concerned about the lack of accountability of the existing SCRG.

69. Proposals for the formation of the new group were taken forward in January 1996. The agenda for the first discussions incorporated extensive documentation. It explained the existing groups. The Control of Systems and Procedures Group had emerged from a review of payment authorisation procedures and had commissioned a study of risks perceived by line management. The Risks and Controls Group had been formed following SCRG reviews on "data" and risks. Neither group had written terms of reference. They appeared to overlap, but in total they failed to cover the relevant areas comprehensively. The proposal was formalised: that the two groups be joined with the object of discussing all aspects relating to security, risks and controls. This new group could report to the managing director and through him to the audit committee on its activities and findings. The proposals for membership reflected the range of its intended functions, which covered the company secretary's area, accounting, policy data and internal review (which meant the SCRG), individual business and international administration, actuarial areas and group business.

70. Meanwhile the position of the existing SCRG within the new arrangements was the subject of debate. There had been an objection to a topic selected for review by the SCRG. Driscoll, the assistant general manager who was responsible for the SCRG, responded on 26 January 1996. He was concerned to assert the independence of the SCRG from the new group. He argued that that was set out in its terms of reference and was also the basis of operation presented to and understood and effectively ratified by the Society's audit committee. (The implication was that the June 1996 terms of reference had already been adopted in practice.) It was critical to proper discharge of the duties of the unit. The unit was ultimately accountable on the one hand to Ranson and on the other to the audit committee. He argued that the existence of the new risks and controls group changed nothing as regards the independence of the function. He would not accept that it was appropriate for that group in effect to dictate what reviews would or would not be undertaken. He preferred co-operation between the two groups. It was a powerful assertion of the role of SCRG. But it did not divert the progress of the new proposal. The formation of the new group, the SRCG, proceeded.

71. The SRCG met on 5 February 1996. Bowley commented that the proposal for the new group followed the memo from Ranson to assistant general managers and senior managers dated 26 August 1993[15], and the establishment of and reporting by SCRG. He commented on the need to be in a position to give comfort to the audit committee on relevant matters. The group could assist the GMT by providing material for decisions. SCRG would not be "constrained" by this group, but the new group would have the opportunity to feed in views to SCRG on areas for investigation. The terms of reference were substantially as proposed already:

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[15] See paragraph 51 above.

"1. To draft statements of the principles/standards* to be applied to ensure the Society's security objectives and internal controls are effective.

2. To identify areas where risk is perceived to exist* and to review the management of that risk and its effectiveness against the standards set by the GMT.

3. To review the adequacy of security and control measures within systems (mechanised and manual) in accordance with the Operational Principles issued [on 26 August 1993] and to develop these Principles into documents capable of practical application.

4. To review the Society's (and subsidiaries') arrangements for deterring, for identifying and for handling fraud, whether internal or external.

5. To make recommendations to the GMT regarding the above.

6. To provide assistance for the GMT to make periodic reports to the Audit Committee on the levels of risk perceived and on the Society's and subsidiaries' management of these risks.

*where not already defined or identified"

The initial tasks for the group were listed: (1) to make recommendations for principles/standards to apply on access, management control, and authorisation; (2) to summarise the SCRG review recommendations; and (3) consideration of SCRG's proposed future reviews.

72. The audit committee began to express an interest in becoming more involved in the area of risk at about this time. On 5 March 1996 Hirst wrote to Bowley commenting on a proposal by Alan Tritton on 1 March 1996 that an item be included on the agenda for the audit committee relating to risk management. The issue had been raised at the January 1996 board meeting. Hirst enclosed a lengthy paper in which he asserted that existing arrangements were comprehensive and well established and required little change. He mentioned the formation of the new SRCG and suggested that the terms of reference of the audit committee should be amended to include regular reporting by that group to the audit committee.

73. The proposed paper stated that Tritton's proposal was that, while the formation of a formally constituted board sub-committee - a risk management committee - might be inappropriate, the audit committee would be willing to consider the topic specifically at forthcoming meetings. The audit committee would take account of the detailed reports which had already been produced or which were planned, and consideration would be given to widening the terms of reference of the audit committee in an appropriate way. The paper contended that the Society had established various mechanisms, forming part of the internal control framework, to identify, monitor and manage business risks. The mechanisms were part of the framework described in the corporate governance statement in the 1995 report and accounts. Included in the list of topics covered, Hirst mentioned the monitoring of actuarial management reports. These considered, inter alia, solvency; the implications of revenue and solvency projections for investment policy; and the bonus declaration and policy considerations relating thereto. He referred to the proposals to widen the audit committee remit to include the review of the Society's statement on internal control (to be included in the report and accounts) prior to endorsement by the Board; and the receiving and monitoring of reports from both the external auditors and the SCRG. He outlined the purpose of the SCRG. This did not include actuarial management matters.

74. The rationale for the new SRCG was set out. There were principles of operation formulated to combat the risks that the GMT had decided were not acceptable. The relevant operational principles had been issued to assistant general managers and senior managers by Ranson on 26 August. He said it had become clear that a formal mechanism was needed to give comfort to the GMT and to the Board that the Society's security and risk management objectives had been and were being met and

that internal controls were effective. He drew attention specifically to one of the terms of reference requiring the group to provide assistance to the GMT to make periodic reports to the audit committee on the levels of risk perceived and the Society's and its subsidiaries' management of these risks. In the circumstances, no material changes were proposed to the Society's existing approach to identification, monitoring and management of risk other than to extend the terms of reference of the audit committee to include the following:

> "To receive reports from the Security, Risks and Controls group on the levels of risk perceived and on the Society's and its subsidiaries management of those risks; and to receive reports on specific topics commissioned by the Committee or by the Board for consideration by the Committee."

75. The terms of reference of the new SRCG were set out at length, supporting a conclusion that a single group, which addressed all areas of the Society's operations, would assist the identification and investigation of potential security risks and enable concerns to be promptly addressed, and give SCRG (the existing review group) a formal route specifically to raise issues needing general management action. The assertion of management was that it was preferable that risk management should come through management and staff working within the "checks and balances that operate within the organisation", rather than through a committee's consideration of the detail. It was said that:

> "... in general the understanding of risks and through it decisions as to their management or recommendations concerning this, where reserved for Board decision, is more likely of success when undertaken by management and staff in performance of their duties, within the checks and balances that operate within the organisation."

Detail would not address "the issue which would be key to the Board". The proposed statement concluded:

> "The Society's approach to the management of the risks in the operation of its business is established, wide-ranging and comprehensive.
>
> Existing procedures enable appropriate reporting to the Board in relation to operational and financial risks, although it is recommended that the Terms of Reference of the Audit Committee should be extended to enable it to review reports from the newly formed Security, Risks and Controls group."

76. On 25 March Tritton wrote to Bowley. He said that he had come to be increasingly of the view that, provided the Society had very tight internal operational controls, duly sanctioned limits for counter party or settlements risks, derivative exposures and so on, then the responsibility for the business risks incurred by the Society were properly the concern of the Board as a whole and not that of a committee. He saw no reason for a risk management committee per se. The risks referred to could and should be dealt with by the audit and investment committees. Bowley replied on 29 March. He agreed that, given the financial nature of the Society's business it was unlikely to be sensible to divorce risk assessments and controls from the Board and the existing committees.

77. Tritton's letter revealed no knowledge of Hirst's proposals, nor of the extent to which the new committee structure had proceeded. On 18 March 1996 the SRCG met. The minutes noted that the audit committee had been briefed about the group, but that item 6 of the group's terms of reference (to provide assistance to the GMT and to make periodic reports to the audit committee on risk and on the Society's and subsidiaries' management of risks) had not been included in the audit committee papers and should therefore be taken as an "in brackets" addition to the terms for the group's use only. The file copies of the terms of reference at the time similarly excluded item 6.

78. On 15 April Bowley reported that a paper on risks was being prepared for the next meeting of the audit committee. On 5 June there was a further internal memo

copied to senior management expressing concern on the scope of the remit of the SRCG. Following some debate, the minutes of the SRCG for 18 June 1996 recorded agreement among management on the way forward. They would prepare internal controls and related guidance, including details of a self assessment approach and instructions as to what managers needed to do; a paper on current office rules, initially relating to confidentiality, access and authorisation and any related guidance. The requirements for effective instructions were set out. SCRG was to review the self assessment results as part of the process of being able to give reasonable assurance to general management and directors on internal controls. Forms for the self-assessment exercise were to be drafted. Detailed procedures were worked out. The analysis of risks continued.

79. Directors meantime continued to express interest in the management structure. On 13 June 1996, Peter Davis wrote to Bowley asking about the SCRG. He had identified areas that were within the scope of SCRG review but were regarded as falling outside the remit of the audit committee. He wanted to know the procedure for following up points which were outside the focus of the audit committee, so that the Board could be satisfied that there were no points that were accidentally omitted from follow-up procedure. He wanted a specific mechanism for the Board (or the audit committee) to have assurance in relation to compliance with DTI guidance notes, which the Board was required to certify in the DTI return, and wanted to know whether SCRG provided this. And he asked for a sight of any background papers on the establishment of the SCRG, and whether there were minutes of any decision not to have an internal audit function.

80. On 1 July 1996 Bowley wrote to Ranson enclosing his draft reply to Davis, explaining "why we do not have internal audit and how we set about controlling corporate risk", and asking whether it might be shown to Tritton who had asked to see the reply in draft. There was extensive internal discussion. On 8 July Bowley circulated a document re-stating the 'Office Principles of Operation'. The principles covered confidentiality; access to data and authority to initiate change; and requirements for authorisation of actions, with illustrative discussion of the principles in operation.

81. On 12 July Tritton wrote to Bowley approving the reply to Davis. He outlined his own views on risk. He identified the business risk incurred by the Society as properly the concern of the Board. He considered that the operational risk incurred by the Society in the furtherance of its business could legitimately be delegated to the audit committee, who needed to take a view as to the management and control of these operational risks. He commented that at the end of the day, the most important thing was for the Society not to get caught out by a major loss, which with the benefit of hindsight it should have foreseen and controlled.

82. Bowley sent a copy of Tritton's letter to Ranson on 16 July, commenting that it gave a clue to Tritton's views on risk. Bowley suggested that there was clearly some confusion in Tritton's mind about the part management should play and the extent of monitoring. That would need to be addressed through "the 'risk' note" and discussion of it at the audit committee.

83. The SRCG met on 22 July, and agreed the form of papers to go to Ranson for scrutiny and agreement. The documents were sent to Ranson on 1 August 1996. The covering memo referred to the paper on risk management presented at the March 1996 audit committee meeting which gave the background to the formation of the SRCG, and to the audit committee's discussion of the need to give directorsreassurance as to the effectiveness of controls and any statement to be made in the report and accounts in relation to this. The documents were said to concentrate on: raising awareness of the topic and of managers' responsibilities in relation to it; a statement of principles in selected areas; and information gathering from which assessments as to the effectiveness of controls could be undertaken. The means of gathering the information that was proposed was self-assessment by managers of the risk and controls in their area. Drafts were submitted of an internal

controls paper, with a hypothetical self-assessment exercise, and revised office principles of operation.

84. The documents were approved for distribution and were sent out with the SRCG minutes of 30 August. These included documents on internal controls, principles and related guidance. It was agreed to start trials of the self-assessment exercise. The aim was thereafter to finish the self-assessment exercise for the whole office by mid-December, so that a report could be made to the March audit committee. There was discussion of a note of corporate risks. Ranson considered it to be too detailed, and a "higher level" version had been drafted for further discussion. Revised payment authorisation rules were discussed and there were proposals for a simplified authorisation for 'system controlled' payments, with current arrangements continuing, subject to clarifying the position on streams of payment, ex-gratia payments and writing-off of debts. Thereafter there would be proposals and a draft Board paper to be considered by the SRCG. There were proposals for SCRG's future reviews. Topics for future meetings of the SRCG were noted, including deterring, identifying and handling fraud, and various principles of operation that needed to be developed, and corporate risks.

85. Hirst sent Bowley a further memo on 5 September relating to corporate governance. He referred to the proposal that had gone to the March 1996 audit committee that the statement in the 1995 accounts on governance should be extended to indicate that the Board reviewed the effectiveness of the system of internal control regularly and to set out the form of the internal control framework. He attached the draft statement as considered by the committee and the minutes of that meeting. He pointed out that the latter referred to removal of the control framework section of the statement on internal control; the fact that the subject should be taken before another meeting of the audit committee; and that, as noted by Ranson, the duties of the directors of insurance companies were relevant. He enclosed a "re-issue" of part of his paper on corporate governance dated 30 January 1996, which, he said, provided background information on the current position on the guidance to directors' on statements of internal financial control.

86. The development and refinement of the statements continued. On 17 September Bowley wrote again to Ranson. He commented that management was committed to preparing some sort of statement to the audit committee related to "the main risks faced by the Society and the actions being taken to avoid or reduce them", for consideration by the committee before submission to the Board. He noted that Ranson was still unhappy with Driscoll's second note of risks primarily because of his desire to ensure the Board focused on the risks inherent in strategic direction and delegated all other risks to management, monitored in only limited areas by the investment committee, audit committee and auditors.

87. Bowley also noted that Ranson had raised the duties of the directors in this context, and that he considered that they should not be involved in detailed management aspects of the business. He mentioned that management was concerned to ensure that the Society's disclosure in the report and accounts was reasonably up to date on the related subject of internal control. Top management, he suggested, needed to clarify how to handle the risk management topic and also the effectiveness of internal control with the audit committee and the Board. He referred to the approach adopted by other life offices and sent the material Hirst had recovered from other offices. Bowley appears to have tried to encourage a more sympathetic view. He said:

> "The enclosed copies of section of the relevant paragraphs of some insurance companies' reports may be helpful. In all three cases the Audit committee is involved in reviewing management reports including risk, as well as internal controls (or internal financial control). I suspect the Scottish Widows' approach might appeal to you - the question is how to convince our Audit Committee that our management activities are sufficient which too high a level will not achieve."

At about this time, the draft annual report of the SCRG to the audit committee was circulated for review.

88. On 24 September Bowley wrote to Tritton, Davis and Martin. He referred to the history of the request for a brief statement of the main risks faced by the Society and the actions being taken to avoid or reduce them. He referred to the time and effort put into the exercise. He said that it had become increasingly evident, which perhaps they should have recognised at the audit committee meeting, that whatever was contained in such a statement could only ever be examples, whatever the level at which one pitched a statement of risks. This led to the conclusion that:

> "This should not be taken as an inability to identify current risks, although inevitably risks must exist which are not identified. Rather it is the risks that present or may present themselves in the future that are relevant. Some can be speculated on but an unknown number must be that (i.e. unknown). If we accept that a statement can only ever be examples from an unknown population then we feel that such a statement would be severely limited in value.
>
> Where this is leading to is that we have concluded, on reflection, that a statement which covers superficially specific risks would be inappropriate. Presentation of specifics is almost certain, we feel, to lead to concentration on consideration of those specifics (i.e. on the detail of individual risk areas and their management). It is that which we regard as inappropriate."

89. Two reasons were advanced for this conclusion. First, risk had dependencies that might be variable. And the information necessary to understand risks across a wide range and in particular their dependencies and complexities could not be conveyed successfully to a committee, however constituted, and especially by what would by definition be a brief statement. Bowley advanced the view, on behalf of the executives, that

> "... in general, the understanding of risks and through it decisions as to their management or recommendations concerning this, where reserved for Board decision, is more likely of success when undertaken by management and staff in performance of their duties, within the checks and balances that operate within the organisation.

Secondly, the consideration of the detail would, by its nature, add little or nothing by way of addressing the issue that should be key to the Board, which was the ability of the organisation to: anticipate risk whenever and wherever it might occur; assess the extent and likelihood of risk; where appropriate, avoid risk; where risk was not or could not be avoided, reduce, where appropriate the chances of it occurring; and where risk occurred, mitigate its affect. In these areas, management felt that the Board would wish to be reassured as to the processes relating to these matters and allied to that the quality and culture of the organisation. He said that the paper presented to the March audit committee had described the framework, a framework which should give an appropriate level of reassurance. The detail contained in the items within the framework provided opportunity for that reassurance to be reinforced.

90. The letter had presented management's case for excluding the audit committee from risk assessment. The debate continued at the next audit committee meeting in October 1996. There was discussion of the fact that both the SCRG and the SRCG reported to management, not directly to the audit committee. This led to a discussion of the structure of the two groups and whether they ensured that the directors were able to keep effective internal control. [16]

91. Finally, on 7 November, there was wide circulation of a full series of papers. The covering letter from Bowley described the work of the SRCG "undertaken to date

[16] Davis (understandably) found the names of the groups confusing. It was proposed that the newer group, the SRCG should be re-named the internal controls review group.

by the Group and approved by RHR". Appended were the terms of reference of the SRCG.

92. Relationships with the audit committee remained difficult, and Davis in particular continued to press his views. An internal memo by Bowley of a meeting with Davis recorded the latter's concerns. Davis did not accept the arguments put up in the September letter and wanted to readdress the absence of a risk note along the lines he had suggested. Bowley said he had outlined the role of management in terms of responsibility for internal analysis and control of risk; and the need to enable directors to be satisfied that this subject was under control, thereby enabling them to give the assurance as in the report and accounts. Davis had not accepted that that meant the audit committee members should not see a little way behind the curtain and get answers to reasonable questions such as the risk list and handling review he asked for. Bowley had suggested that he await issue of an explanatory note about the total structure covering Board and GMT responsibilities and the fit of the SRCG with the SCRG. Davis had agreed to do that, but proposed to raise his request for the risk data with Tritton as chairman of the audit committee. He saw the need for greater comfort and felt that the risk schedule would help. Bowley recorded that he thought that Davis might also express a wish to talk to the auditors about the general approach to this matter of control at the Society in order to be sure that they were satisfied. But Bowley had confirmed that Davis did not have a wish to move to any internal audit "formation" in the Society.

93. A draft of the note on roles was circulated to senior management for comment on 13 November. The covering memo from Driscoll explained management's view that the original requirement for the note resulted from uncertainty as to the respective roles of the SRCG and SCRG. But that was too narrow a perspective. The note should have a wider scope and in the process touch on the matter of Board and executive responsibility. Subject to other observations, the note would be submitted to Ranson for final agreement.

94. The contents and tone of the exchanges says much about executive attitudes. Consistent with those attitudes was the report of Bowley to the SCRG on 11 November:

> "1. RQB reported that it is intended that the GMT should make an annual report to the Audit Committee (with help from the Security, Risks & Controls Group) rather than such a report to be from the Group itself."

95. The revised note was sent to audit committee members on 31 December. The covering letter from Bowley expressed the hope that the note, agreed by senior management, "will not only clarify the position but also move forward the support to directors in relation to ensuring effective internal control". In particular committee members would see from the note that future annual reports on internal control would be made by the general management team (GMT) to the audit committee and through that committee to the Board. At this stage in the proposals there appeared to have been some movement towards relaxing executive ownership of risk management.

96. The note recorded that the directors were ultimately responsible for establishing and monitoring that the Society had in place an appropriate system of internal controls. This was acknowledged publicly in the report and accounts. The objective of the audit committee, as stated in its terms of reference, was to assist the Board in this matter, among other things. The executive responsibility for "establishing and monitoring" rested with the GMT. It was incumbent on the GMT to satisfy the Board that the GMT had given proper discharge to their executive responsibility and for the Board to rely on this and such other information as they required or was available to them (e.g. the external auditors' management letter) with regard to discharge of their ultimate responsibility in relation to internal controls. In general it would be the case that the audit committee would act on behalf of the Board.

97. The re-naming of the SRCG as the 'Internal Controls Review Team' (ICRT) was noted. This arrangement complemented rather than replaced assistance provided by individual members of the Society's management. Whether through the ICRT or individual members of the Society's management, the GMT might empower those concerned to take actions on its behalf and require that the results of those actions were monitored. In this context, the note stated, it was clear that the matter of reporting to the audit committee had been somewhat misdirected. It was proposed that:

i. The GMT report formally to the audit committee, at least annually, on internal controls. The purpose would be to assist in providing reassurance as to the effectiveness of the Society's system of internal control (i.e. satisfying the Board, via the audit committee, as to the proper discharge of the GMT's responsibility in this area). Unless specific features were worthy of comment this report would tend to provide reassurance as to the general effectiveness of the systems of internal control.

ii. SCRG continued to submit an annual report to the audit committee, covering in summary form the reviews and their findings undertaken in the previous period. By its nature such a report provided reassurance as to the existence and effectiveness of internal controls in respect of particular parts and functions of the Society.

98. As at the end of 1996, therefore, the efforts of the audit committee to obtain an analysis of the risks confronting the Society appeared to have been frustrated. The GMT would not have full and formal reporting responsibilities to the audit committee on internal control. Reassurance on management's performance did not allow for full review or investigation.

99. Whatever other risks there might have been, had this been the end of the matter the result would have prevented the audit committee from having access to information about the product and other valuation risks confronting the Society, except insofar as they were reported on in the actuaries' reports to the Board. The annuity guarantee risk had not been reported to the audit committee, nor were the various valuation issues discussed above[17]. The Board could have revoked any existing delegation of powers to executive management, but had not taken such a step.

100. The renamed ICRT met on 20 January 1997, when the papers brought forward from 1996 were discussed further. In relation to reporting it was minuted that the audit committee had been told that the team existed to assist the GMT in the performance of management duties, and that the GMT would report annually to the audit committee in October.

101. At the first audit committee meeting for that year, on 12 March 1997, the committee were told that they would receive a report on internal controls in October. A member of the committee asked for, and was given, confirmation that if any major problem were clear to the GMT at any time, it would be brought to the Board's attention as it arose without awaiting the October report. It was also said that a more frequent interim report might be helpful. Meantime the self-assessment exercise continued.

102. No problems were reported at the June and July meetings of the audit committee. At the audit committee meeting of 8 October 1997 Driscoll presented the first annual report on internal control. He outlined the systems in operation directed towards providing reasonable reassurance with respect to: the business being operated efficiently and effectively; the safeguarding of assets against unauthorised use or disposition; the maintenance of proper records and the reliability of financial information used within the business or for publication; and compliance with laws

[17] See chapter 6.

and regulations. He referred to comments by Ranson that the Society's "cohesive" approach to principles of operation differentiated it from many other organisations, and it itself acted as a control. He and Hirst commented on the self-assessment exercise. Directors asked for further information on the self-assessment exercise.

103. Of more central importance for present purposes, directors returned to the issue of a list of the main risks to which the Society was subject. The issue had been behind the papers submitted in March. Nash and Bowley agreed to "consider further what could usefully be provided". There was discussion whether a risk management function would be appropriate, in view of the potential for certain risks not to be addressed adequately. It was agreed that the issue would be considered. The directors had not been deterred from pursuing their interest in risk management. On 8 October there was a private meeting between the audit committee and the auditors, Ernst & Young. Arising from comments then and in subsequent discussions between Nash, Sclater and Tritton, arrangements were made for a further meeting with the auditors on 22 December to discuss risk.

104. The further development of risk management was discussed at the meeting of the ICRT on 21 November 1997. A package of materials on the self-assessment exercise and a risk list were to be issued to the audit committee after the planned meeting with the auditors. It was noted that the auditors had expressed some concern over the Society's somewhat fragmented approach to risk management and the possibility of "holes". Nash undertook to consider whether Davis should be invited to attend the meeting with the auditors. In relation to risk management generally, the team considered that it should be renamed the 'Risk Management Group' and have suitable revised terms of reference. The context remained as before: the body responsible for "risk management" was the GMT (i.e. the general managers only) with those principally responsible being Nash, Bowley and Driscoll. This marked a significant point in the development of risk management systems. The audit committee was to have the risk list that had been sought for some time. There was to be a full assessment of the issues with the auditors. And there was recognition that there might be deficiencies.

105. Ranson had retired in July. Hirst told the inquiry that it was his recollection that towards the back end of 1997 there was a lot of pressure from non-executive directors to implement change in relation to a number of matters, including risk and internal audit. In Hirst's view they saw the retirement of Ranson as presenting an opportunity to make changes. He said Ranson had been a strong character, a clever man, difficult to challenge. The meeting on 8 October with Ernst & Young gave the auditorsan opportunity to make a presentation on risk. Davis attended the meeting. In preparation for the meeting Driscoll prepared a document analysing the existing system of risk management and controls.

106. Driscoll's document drew heavily on earlier statements. It identified five 'entities' as components of the system: the Board; the Executive; independent functions of a corporate nature; independent functions specific to particular operational activities; and line management. The Board was ultimately responsible for establishing and monitoring that the Society had in place an appropriate system of internal controls; and for identifying risks and ensuring that those risks were appropriately managed and controlled. Board committees,. principally the Audit Committee and the Investment Committee assisted the Board in this matter. In general the responsibility for identifying, monitoring and controlling risks, and for establishing and monitoring controls had been delegated to the executive. It was incumbent on the executive to satisfy the Board that the executive had discharged their responsibility and for the Board to rely on this and such other information as they required or was available to them. The executive was concerned with setting policy and overseeing the control environment, on occasion through management groups. The ICRT had an overall business risk management responsibility and policy-setting role in respect of risk management (in particular those of a corporate nature) and controls. The SCRG was an example of an independent function of a corporate nature. Line management would establish when necessary, and operate,

controls to mitigate risks to their own part of the business, and to ensure quality of the end product.

107. The meeting on 22 December discussed risk management and internal audit widely. The auditors discussed and illustrated current trends. Davis stated that he believed that from a systems and product development perspective business risks were well understood and acknowledged. However, the Society was now a group and faced a diversity of risk. Ernst & Young expressed concern whether the Society was confident that all change programmes "added up" to meet the corporate strategy. Driscoll went over his paper on the Society's current framework for risk management and controls. Nash said that he believed the control framework to be reasonable and comprehensive albeit not of a standard format. He asked whether others had concerns about or perceived there to be "gaps" in the approach.

108. Ernst & Young noted a long-standing concern regarding the absence of traditional internal audit, in particular the absence of any formal checking function. Ranson's view had been that there was a need to trust management. Ranson had also claimed that the review group, SCRG, had a preventative role, but in the auditors' view that did not accord with practice. The skill set of SCRG might be deficient in various aspects, for example knowledge and understanding of fund management activities. Davis, however, was supportive of the executive on this point, stating that the Society had a developed risk management culture and, in particular, exercised strong business controls. The Society's approach to risk management was more than operational/preventative, although he was of the view that there was a need for some more traditional internal audit work (checking) to be undertaken.

109. Davis said that his long-standing worries regarding the Society's approach to risk management related to:

i. a concern that the Board was being prevented from understanding what risks the business faced and how those risks were managed and controlled.

ii. a lack of clarity about responsibility for risk management and the reporting in relation thereto.

He expressed the view that the Society would move rapidly in the right direction if (ii) could be improved. He thought that the Society should continue to operate on the basis that line management had a key role to play in establishing and operating controls to mitigate risks. But he was concerned whether line management understood the business risks in the functions for which they had responsibility.

110. Ernst & Young noted that solvency management was always going to be a central concern for the Society, given the policy of full distribution, and questioned whether investment managers did really understand that risk and the impact that their actions could have. Davis said that there was a need for the Society to develop a policy statement on business risk management and control and for that statement to be promulgated to and implemented by all companies in the Group. A single document would help to focus the attention of the Board and all in positions of responsibility within the business. Bowley agreed with this view.

111. On 23 December Bowley briefed the ICRT on the meeting with the auditors. He reported that the main conclusions of the meeting were that the Society should review its "hands off" approach to subsidiaries and take a more active role in respect of the investment area. The record of the ICRT meeting does not disclose Davis's concerns regarding the Board being prevented from understanding what risks the business faced, nor Ernst & Young's concerns that the Society should revise its approach to risk management generally. The minutes recorded that the risk list was to be sent to the audit committee with an 'overview' document and a note of action being taken to deal with hostile takeovers, fraud, subsidiaries, and overseas operations.

112. On 14 January 1998 Davis sent Tritton a copy of his notes of the meeting with the auditors. Tritton replied on 19 January. He rehearsed the steps that had been taken to deal with risk, mentioning the audit committee, the SCRG, the ICRT and the regular reporting structures. He was not convinced that there was a case for another risk management committee. Significantly, he repeated his usual concern:

> "There are many concerns and worries which we have in managing the Equitable business but these pale into insignificance compared with our solvency and free asset ratio risks and the extent of our guarantee liabilities. These are very much a Board responsibility and indeed are regularly brought to the attention of the Board."

At that stage the annuity guarantee problem had not been discussed with the Board or the audit committee: Tritton's concern was with the solvency position as reported by the actuaries.

113. The risk list, initially requested by the audit committee in March 1996, and the overview prepared by Driscoll, were distributed by Nash to the audit committee on 29 January 1998. The list was not new, it had been prepared in June 1996. It contained broadly the same heads of risk, although differing in detail, as the overview statement. Nash's letter observed that a brief statement of risks could only ever contain examples and could not indicate all risk dependencies. He identified a range of risks to which particular attention was being paid in January 1998, which were the same issues referred to in the ICRT minutes: hostile takeovers, fraud, subsidiaries, and overseas operations. He told the audit committee that the role of the ICRT had been extended and enhanced, and that it had been renamed (again) as the Risk Management Group (RMG) to give a clearer picture of its remit.

114. Driscoll's overview described the categorisation of risks adopted:

i. Risks relating to the continued existence of the Society as a business.

ii. Risks relating to the provision of the service by the Society to its policyholders.

iii. Risks relating to the monies invested by policyholders and the returns on such monies.

He warned that the categories did not exist independently, but interacted upon each other. The list did not, other than in very broad terms, attempt to assess the probability of the risks crystallising adversely or of the impact should that happen. It did not offer a view as to the effectiveness of the actions identified either in theory or in practice. However, subject to all of the qualifications expressed, the audit committee had been provided for the first time with an assessment of the risks identified by management[18]. Against the background of developments at the end of 1997, it appears that the newly established risk management group was an innovative step for the Society in the direction of integrated risk management of a kind that had not existed previously, with a reporting line that would ensure a flow of information to the Board through the audit committee in the fullness of time. But the developments were late in time as events were to prove.

115. All three members of the audit committee responded to Nash's letter. Martin observed on 30 January 1998 that he supposed that the Society's biggest real risks, as contrasted with nightmares, were regulatory and computers, which, as expected, were well covered. He suggested disaster scenario testing: thinking the unthinkable. Tritton wrote on 13 February 1998. His view was that all business was a risk activity and that the proper recognition of the risks inherent in business, and the management and balancing of those risks were of paramount importance. In the light of the list, he was satisfied that there was a proper recognition of the risks undertaken by the Society and that the necessary control mechanisms were in place

[18] It is of note that at this stage, in January 1998, the risk list dealt with guarantees in broad and general terms. There was no reference to annuity guarantees as a particular issue.

for the management of these risks. He expressed his reservations about solvency margins:

> "I have, however, one caveat and this may or not be a personal view, I do not know. However, it is my belief that the Equitable as a mutual is managed too close to the margin. Now I know and I understand and appreciate all the reasons why this should be the case and philosophically do not disagree with the tenets of full, fair and equitable distribution of annual surpluses. However, I do believe that there is an increasing risk to the independence of the Society from this annual desire to distribute to the limit.
>
> I also observe rightly or wrongly that the effect of such a distribution-policy is beginning to tighten our position. If it is not, why are we going down the subordinated loan stock route, why are we taking in more and more from future profits and so on. It may be that this all results from greater proportion of fixed interest stocks in our investment portfolio compared with other houses - I really do not know. All I know is that I am beginning to feel uncomfortable with the business being run so close to the margin and that this could well be the greatest risk we are running."

He had consistently raised the issue over a period of time: the risk list clearly failed to focus the issue to his satisfaction.

116. Davis wrote to Nash on 9 March. He described the statement of risks as an excellent piece of work; more or less exactly what he had had in mind when he requested one. He commented that it covered the ground comprehensively, and offered some minor comments. He also raised the issue of contingency or disaster planning. He welcomed the further development of the remit of the risk management group, but still sought greater clarity and documentation of the group's policies and objectives.

117. Nash replied to Martin's letter on 5 February. He dealt with hardware risks, and went on to discuss the risk of failure to meet regulatory requirements, an idea that filled everyone with concern. He said that management would consider whether a practical test could be set in to the programme at some stage. He commented that there would be little time for discussion of the statement of risks at the March audit committee meeting.

118. Nash replied to Tritton at length on 23 February 1998. The reply was an important re-statement of the Society's position in relation to solvency and distribution, and it presented a direct challenge to Tritton on policy. It also indicated the extent to which the Society had lost flexibility as a result of the policies and practices it had applied in the past. Nash wrote:

> "Thank you for your letter of 13 February 1998. ...
>
> The first point I would make is that I do not believe that it is the annual distribution of surplus as declared bonus which is a major contribution to the 'tightening of margins' you describe. Since the late 1980s we have managed down the level of declared bonuses in line with falling yields, probably more aggressively than most other offices. In terms of the level of guaranteed returns we pass on through the declared bonus system we are below average.
>
> The 'full distribution' philosophy applies to total policy proceeds and is most pertinent to the determination of final bonuses. There we could retain earnings from maturing policies to build up genuinely 'free' assets. However, total final bonus payments last year were £390m. If we had retained, say, 10% of that, that would only have contributed £39m to free assets. If we had done that consistently over, say, the last 10 years we might have built up around £¼bn of 'free' assets but that would still only be 0.3 of the minimum solvency margin. Building up sufficient free assets to have a material effect on the solvency position would give us a different problem - namely what, equitably, should be done with those free assets.

It is unarguable that the valuation regulations are more stringent in a low interest rate climate, that the 1994 regulatory changes reduced the room for manoeuvre and that the removal of dividend tax credits has led to higher reserves on pension business. I think it is important, however, not to get the position out of perspective. The ratio of available assets to the minimum solvency margin was 2.4 at 31 December 1992. Despite the factors described above and the rapid growth in business over the last 5 years, the ratio at 31 December 1997 is still 2.4 (and might creep up to 2.5 when all the figures are finalised). That does not seem, to me, evidence of a significant deterioration. We need to be careful that the greater focus we are now giving to our solvency position (which I regard as entirely appropriate) does not lead us to worry unduly.

As has been said on previous occasions, managing a with-profits office is all about striking a balance between conflicting factors. If the Board wants a significant improvement in the margin of solvency the following courses of action are open to it:

(i) Give a much greater emphasis to fixed interest stocks in the asset mix - that carries the risk of significant underperformance of our policies relative to the market.

(ii) Change the distribution policy to retain a significant proportion of earnings from maturing policies - as noted above, that will take some time to be effective. Meanwhile the competitiveness of our products would be significantly weakened and a central plank of the philosophy which characterises the Society would be destroyed.

(iii) Reduce new business levels significantly - that will lead to a short-term reduction in cost-effectiveness, carries the risk of not being able to 'restart' new business at some future point and increases vulnerability to a predator.

(iv) Reduce significantly, or eliminate, declared bonuses - the risks associated with such a course were discussed at the January Board.

All the above options carry significant risks of wrecking the business. Those risks need to be balanced against the risks you describe. There is no risk free option.

Whilst maintaining the current general approach there are, of course, incremental things that can be done. My management colleagues and I are addressing those. We have recommended, and implemented, a cut in declared bonus rates this year. The popular managed pension contract is being relaunched in a form which makes significantly lower capital demands. A number of other initiatives are in progress and my colleagues are mindful of the need to be vigilant to other possibilities. Over time these things will all help but I should be very concerned at the thought of a much more dramatic change of direction, of the types described above.

I hope these initial thoughts are of interest. Perhaps we could have a word at a convenient point as to how best to take this forward."

119. The audit committee met on 11 March. It was minuted:

"8. Risk Management. Consideration of brief reports on

- the Society's approach to the management of risk
- the main risks faced by the Society

The General Manager - Systems and Controls, David Driscoll (DCD), introduced the reports and commented that they were intended to provide an appreciation of the control framework which operated within the Society and the interaction of the various entities of which the framework comprised.

> The Chairman of the Audit Committee, Alan Tritton (AGT), referred to correspondence he had had with the Managing Director and Actuary, Alan Nash (AN), regarding risks and their management. AGT commented that he was satisfied the Society recognised and controlled risks appropriately. AN commented that he considered the Society's control of risks had improved, both conceptually and operationally, and that the role of the Audit Committee and the other structures in place had significantly assisted in this.
>
> There was discussion of the section of the report entitled "Risks and their management" and of the list of risks within that. It was agreed that 'reputational risk' should be included as a separate item in that list. It was agreed that the list of risks should be considered by the Audit Committee once a year, as part of the Risk Management Group's report to the Committee."

120. Tritton's concerns appeared to have been dealt with. He told the inquiry that his concerns about the changing financial position of the Society were instinctive rather than reflective of views formed on information he had had and figures he had seen. His letter to Nash reflected a feeling that the management was running the business too close to the margin. He interpreted Nash's reply as an indication that the directors should not worry unduly about the solvency position. His impression was that the ratios of available assets to the minimum solvency margins were not evidence of a significant deterioration in the Society's financial position. Tritton did not pursue the issue of the Society's thin solvency margin because he was concerned as a non-executive director that by trying to force through the options Nash had set out, he would be accused by the Executive of wrecking the business. Tritton told the inquiry, however, that as 1998 progressed the Board, and in particular the non-executive directors, did become progressively more concerned about the solvency margin. But it has to be noted that the annuity guarantee issue and mis-selling were changing the context at that time. In relation to risk management generally, Tritton considered that there was a carefully constructed edifice and he took the view that it was as watertight the Board could make it: no major risk would remain unidentified.

121. The developments at the end of 1997 and beginning of 1998 appear to have taken place without reference to the actuarial department. On 6 March 1998 Headdon wrote to Bowley referring to a number of the risks identified in the risks list that he as appointed actuary had significant responsibilities for, and some for which he had has a direct statutory and professional duty to manage. He said:

> "I must admit that I find it odd that RMG felt able to report to the Audit Committee on the management of those risks without any reference whatsoever to me. If RMG is now going to include a number of actuarial management risks within its remit I feel strongly that I need to be involved."

The risks listed by Headdon as concerning him were typical actuarial areas: inability to meet technical solvency requirements over liabilities; inadequate capital base; mismatch of investment returns with bonus distribution requirements; mismatching of nature of assets and liabilities (type and term); premium rates are set too high (adverse marketing implications) or too low (not viable); adverse mortality experience; premium discontinuance/reduction under variable premium contracts; valuation of assets and liabilities; and policies that contain guarantees or conditions which become onerous.

122. There is a hint of change in the balance of power within the executive. Bowley was surprised by Headdon's concern. He wrote to reassure him that if the time came for his area to be examined, it would be done by self-assessment, with the results examined by the risk management group in consultation with him. He explained that the entries in the risk list sent to the audit committee contained statements of the steps known to be taken in risk mitigation and expressed that view that they should not be contentious. But he agreed that the remit of the RMG had been broadened and that practical review of specific risk areas would as a result be likely to involve various areas of the Society's activities in future. The new risk

assessment exercise would give Headdon an opportunity to record and review with the RMG the specific risk areas for which he and his staff were responsible. Headdon's involvement would be required as the RMG came to study his areas of interest.

123. Tritton returned to the issue of risk management in about September 1998 in the context of the annuity guarantees that had by then emerged. Bowley wrote to him on 30 September. Tritton had asked how the difficulties over the guarantees fitted with the risk management approach adopted to date. Bowley outlined the progress over 1998 in developing risk analysis. He failed to meet the challenge implicit in the question, and offered no answer to the question how the annuity guarantee problem had escaped disclosure by the risk management process that had been developed by management.

124. Bowley discussed the general approach: management had developed many areas of risk management and controls to be exercised in practice, with self-assessment exercises having helped to raise risk profiles among managers and staff. He pointed out that the risks associated with guarantees had been included in the list of risks. He said:

> "As you know, the potential effect of guaranteed annuity options in conditions of falling interest rates was recognised some years ago and action taken to inform relevant clients by way of bonus notices. What was apparently not adequately handled was the way in which that was done (by reference to cutting final bonus to pay for the cost of the guarantees) and our not recognising the PR implications of that approach."

But he assured Tritton that a wide-ranging review was underway on all guarantees offered by the Society and the relevant actions that needed to be addressed to avoid potential problems in future. The reference to Tritton's assumed knowledge, typical of communications between the executive and the Board, was no accurate. As discussed earlier, I have found nothing to indicate that directors generally would have known the background facts relating to the annuity guarantee issue, and the implications of the embryonic policies developed in the early 1980s.

125. In September 1998 management had in hand an assessment of the risk management system, and how it related to best practice, and were planning to engage external consultants. Ernst & Young were commissioned. There were external factors requiring amendment of practices. The audit committee was told of the current position and proposals on 28 October 1998 in the annual report of the RMG on the handling of risks and internal controls. Bowley referred to the principles of operation which had been issued and the further self-assessments which had been completed by managers. He also commented on the review of the risk management capabilities of the Society to be undertaken by Ernst & Young. Tritton commented on the fact that the guaranteed annuity rates issue had not been explicitly identified in the list of potential risks prepared by management. It was reported, as Bowley had earlier commented in his letter to Tritton on 30 September, but apparently without further comment, that the list had referred to guarantees under policies. Ernst & Young set out the scope of the review that had been instructed on 3 November 1998. Nash was involved in the review process. He had met with Ernst & Young "several times" in the autumn of 1998 to discuss risk management.

126. Implementation of the proposals followed. On 4 November 1998 those whom it was intended should be interviewed were informed. Other executives were told of the exercise on 6 November. Ernst & Young's interview process elicited widely varying views of the effectiveness of the SCRG, although the work of the group was generally seen to be positive. The annual self-assessment process was generally viewed as an effective tool for generating risk management discipline throughout the organisation. There were some concern about the group's focus and approach. It was thought by some to look at individual technical issues rather than the business as a whole.

127. The accountants were more critical: they identified a number of problems. The terms of reference of the SCRG did not extend to a risk management role. Rather, it performed a monitoring role, pointing out to the RMG those systems and control procedures that appeared inadequate. The SCRG focused only on operational risks, not strategic or corporate-level risks. The group was relied on by the RMG as its main source of risk identification, and drew on the annual self-appraisal exercise in that connection. But much of the SCRG focus was on the completeness of returns rather than the adequacy of the risk management methodologies/controls being deployed. The self-assessment process only took a "snapshot" view of risk at a point in time - it was static rather than dynamic. SCRG was thought to have limited involvement with business planning. New product development work or business opportunities were evaluated by various steering groups around the organisation. The group's views were not sufficient authority for implementation of recommendations. Overall they considered that there was limited scope for the SCRG and therefore the RMG proactively to identify potential or emerging risks.

128. On 11 February 1999, Hirst wrote to Nash narrating the recent history of risk management within the Society, summarising the views of Ernst & Young, and proposing an approach for the future. He concluded that the Society's approach to risk management had developed in a somewhat piecemeal fashion over the period since early 1993. The audit committee, Ernst & Young and management had all expressed concern regarding the Society's ability to provide the required comfort to the Board that management of risk (strategic and operational) was adequate.

129. Hirst made observations on the origins of the then current position:

> "Our current approach to risk management has its origins in:
>
> - the desire of management to ensure the proper operation of and where appropriate to improve, the Society's control framework. Thus, for example, in August 1993 RHR's published guidance to managers in relation to Operational Principles and, subsequently, what to do in the event of fraud; and SCRG was formed to ensure that office principles and internal procedures were being correctly applied and to assist managers at all levels by pointing out inadequacies, assessing risk and recommending possible courses of action. [Arguably SCRG was formed to placate certain members of the Board who were of the view that the Society should have an internal audit function].
> - the Audit Committee seeking comfort that it was appropriate for the Board to express an opinion on [the effectiveness of] the Society's system of internal control. As the role and confidence of the Audit Committee developed it also began, with some encouragement from EY, to question the scope and terms of reference of SCRG, noting that it did not fulfil the role of an internal audit department; and to ask for the views of management as to the risks faced by the Society [the, so called, "risk list"]."

He also noted that:

> "Our approach to risk management to date has been piecemeal. Indeed, in RHR's time it became the "art of the possible"."

The impression that one might have gained independently that internal control was developed as a rear-guard action at this stage against Board pressure for internal audit is supported by Hirst's assessment of this period. It is plain that Ernst & Young had supported the directors. The "art of the possible" had not allowed for the elaborations and implementation of a sufficiently robust system of risk management and review to uncover material risks in the actuarial area, and in particular the annuity guarantee risks that were then of central importance to the Board.

130. Ernst & Young proposed a wide-ranging revision of current practice. In his memorandum to Nash, Hirst summarised their views as follows:

"In summary, EY do not believe our approach to risk management is sufficiently robust:

- its focus is neither strategic nor operational.
- It is not driven down from clear business objectives (a reiteration of the point they made in December 1997).
- there is no concept of the risk pyramid.
- the "risk list" is not necessarily comprehensive and risks have not been prioritised and mapped on to the risk pyramid.
- our risk management function is under resourced.
- risk awareness and management does not cascade down through the organisation and remains primarily at the GM and AGM level.
- membership of the Risk Management Group does not cover all Group activities."

With some minor exceptions (mainly relating to staff training and appraisal), he supported Ernst & Young's findings and recommendations. He proposed taking further advice, appointing a risk management manager, and development of a comprehensive and effective risk management system. In the light of the annuity guarantee problems, the audit committee would accept nothing less.

131. In my view it is clear that the emergence of the annuity guarantee issue provided the audit committee and the Board with the opportunity to confront the serious limitations on the Board's control over the management of Equitable. It was no longer possible for management to fall back on the plea that the Board should trust management as a substitute for a properly developed system of risk identification and assessment. But the deficiencies were not novel: what was new was a degree of acceptance of the need to deal with them.

132. The position was reported to the audit committee on 9 March 1999, when the intention to appoint a risk management manager was intimated and further reports were promised. Included in these was a re-formulation of the terms of reference of the audit committee including a specific reference to risk management. The meeting was the last attended by Tritton as chairman. Following the meeting, Davis wrote to Roger Bowley on 18 March 1999 asking to see a copy of the Ernst and Young report, commenting that he had 'nothing sinister in mind." On 22 and 23 March Bowley wrote to Hirst and Nash enclosing a draft reply to Davis for comment. Each reflected management's continuing emphasis on preserving aspects of the pre-existing approach. Nash in particular was sensitive to the need to avoid provoking the Board to a response based on the GAR issue. Bowley replied to Davis on 23 March 1999, commenting, inter alia:

> "Risk Management Capability
>
> Thank you for your letter of 18 March 1999. A copy of the E&Y report on this subject is enclosed, as requested. ...
>
> We do however see a need to be sensitive to the fact that we have various strengths and a corporate culture at The Equitable based on a centralised, and in some cases unconventional, approach and that it may not be in our members' interests to change to too great an extent and too rapidly.
>
> The E&Y report makes the recommendation that our approach to the management of risk should have a focus based on the Society's business objectives. In that context, we see the current "risk list" as a helpful starting point in the process of analysing, prioritising, and assessing risks and related controls at the strategic level. For the reasons touched on above, careful consideration will need to be given to any changes we make in the approach to risk at the operational level..."

133. Davis showed Bowley his proposed reply in draft, and it was an amended response that was sent on 6 April. He summarised Ernst & Young's findings and recommendations, identifying some criticisms of the methodology. More particularly, he made comments of his own. In relation to the 'Equitable culture', he was supportive of management, but observed:

> "We must, nevertheless, recognise the heightened potential for loss, fraud and criticism in the present increasingly competitive environment. Indeed, our very uniqueness of approach makes it more than usually necessary that we not only manage the risks properly inherent in running the business, but also can demonstrate that we are doing so. In the current climate, our policyholders would, I believe, want us to rely on the trust culture only so far as we can demonstrate this to be reasonable, and within a control framework which reflects that we are doing so. I am not suggesting that we should adopt a classic internal audit approach, but that, in deciding not to, we have to be particularly attentive to the rigour of the processes, accountability, documentation and reporting in the framework which takes its place and provides alternative assurance.
>
> We have, generally successfully, made line management responsible for compliance matters, with limited central interference and monitoring. It seems clear from the E&Y report that there is some way to go before we can be confident that we have successfully achieved the same for risk management. ...
>
> Risk management is... inherently more difficult to control, record and monitor. Making it a line responsibility can be successful only if we have clear accountability and process, as well as reporting, monitoring and occasional testing of the system."

134. Bowley forwarded the letter to most of the executive members on 8 April 1999 with a note in which, inter alia, he commented that Davis' letter was particularly helpful in pointing up the difference between compliance and risk management and saying: "we would do well to note his conclusions arising from that."

135. The substantive proposals for reform were discussed on 15 June 1999. The committee were in favour of the appointment of a business risk manager. The chairman of the audit committee, now Peter Sedgwick, suggested that there should be an external appointment to head the proposed modern version of 'Internal Audit', which the committee supported. Part of the review and re-launch was likely to include revising the SCRG function. Hirst introduced a discussion of the Turnbull report. He commented on the key implications of the guidance for the Society and the Equitable Group. These included the need to adopt a flexible, risk-based approach to internal control, with a strong risk-management and internal audit capability to support management and the Board. The reviews and actions proposed were said to take account of the report. There was discussion of the guidance and on the need for risk management and internal audit arrangements to cover the whole of the Equitable Group.

136. Meantime discussions continued between Ernst & Young and management. In connection with these discussions with the accountants, Hirst wrote to Nash and Bowley on 14 April setting out a series of questions discussed the day before and what he understood to be Nash's answers. For present purposes it is necessary to note one only. In response to the question whether there should be "no-go" areas - that is functions (such as investments or actuarial) or companies (such as Permanent or ESC) which should fall outside the remit of the central risk management function - Hirst records that Nash's answer was that there should be no "no-go" areas. It appears that that was too general a statement. While operational risks within actuarial functions, e.g. loss of key staff,were considered and reported to Hirst, he told the inquiry that as matters developed:

> "... there was no internal audit review of the actuarial function or the process for determining actuarial liabilities (Had the internal audit function been in existence for longer, some of the systems and procedures in the actuarial areas might well have been appropriate. But internal audit was only formed in May 2000)."

137. Hirst was appointed the manager of risk. He reported to Nash, but had a direct line of access to the president in relation to risk management. Mike Davis, the head of internal audit who had been externally recruited, had a direct line of access to Sedgwick as the chairman of the audit committee. The audit committee approved the appointment of Hirst as the business risk manager at its meeting in October 1999. The committee was told the SCRG would be disbanded to make way for the new business risk department and the internal audit function. The revised terms of reference of the audit committee were put forward at the committee's meeting of February 2000. Equitable had finally a fully developed system of risk management and internal audit. Alas much water had already passed beneath the bridge and the House of Lords decision in *Hyman* was just five months away.

The Audit Committee's Role

138. The principal responsibility of the audit committee over the first few years of its existence was reviewing the report and accounts, with particular regard to:

i. any changes in accounting policies and practices;

ii. major judgmental areas and significant adjustments resulting from the audit;

iii. the going concern assumption compliance with accounting standards.

Compliance with legal requirements, which had been among its initial interests, was not effectively dealt with until 1996 when the compliance officer began reporting to the committee.

139. The financial information given to the committee reflected this view of its role: the members were provided with the statutory accounts and returns, otherwise no financial information was given. According to Hirst's statement to the inquiry, the executive's view was that the numbers in the statutory accounts should not have been a surprise to the committee. The directors would have received monthly reporting packs throughout the year as members of the Board. The only significant changes from the reporting pack would have related to the valuation of investments, finalisation of the tax position and the movements in the technical provisions, including the impact of the bonus declaration. By the end of the first week in March positions in relation to the accounts were known and understood. Hirst would then prepare a paper which presented the report and accounts to the committee. The committee would go through the detail in the accounts and the notes on the accounts. And they would look at disclosures on governance and generally at the wording of the report and accounts booklets. Their interests were as set out in their remit. In general the committee pursued those interests. It is not appropriate to summarise all of the work of the committee. Some examples will serve to illustrate the work done.

140. The committee had an interest in changes in accounting policies and practices. On 14 March 1994 - the first meeting of the audit committee - Tritton questioned the fact that the accounts did not disclose movements on reserves. The period between 1990 and 1993 had seen material changes in the actuarial assumptions underlying the liability valuation, and this was known to Board members. In explaining the way in which life funds were permitted to report, the auditors and Hirst explained the past background relating to the advantages of non-reporting of short-term movements and indicated that there would be a new format of accounts in 1995 when the analysis would include greater detail about liabilities, unit-linked liabilities and any unallocated reserves. The requirement for true and

fair financial statements for life insurance companies was seen as a major change. In March 1995 Ranson told the audit committee of the responsibility for the directors to ensure and the auditors to give an opinion that the accounts are "true and fair". He characterised this as "a first for the life industry". The committee clearly understood that material change was taking place in reporting.

141. But there were limitations on what it was thought the committee could do. At the committee meeting in October 1996 one of the items on the agenda was proposed changes to the format and content of the Society's accounts. Hirst outlined three areas of possible change to the accounts. In discussion, a committee member referred to the need to have regard not only to the responsibilities of the audit committee on behalf of the Board, but also the duties imposed by the Companies Acts and by the Cadbury Code which the Society accepted. He was told that it was not the role of the committee to undertake detailed work and reviews, rather to seek satisfaction that it could rely on management's findings and recommendations.

142. On 8 October 1997 at a meeting of the audit committee, Hirst commented on a

> "... number of changes to disclosures to be made reflecting both the development of the business and changes to generally accepted UK accounting practice. In particular, reference was made to the manner in which Financial Reporting Standard 4 required us to account for the subordinated debt."

143. The minutes of the audit committee show diligence in examining the areas of the Society's financial statements that were considered to be within its remit, with one major exception: there was limited consideration of the valuation of liabilities. Until 1996 the regulatory returns were not within the scope of the committee's remit. But the statutory accounts were, and the liabilities were the most significant item in the balance sheet in what was referred to as the "judgmental" area.

144. As noted above, "major judgmental areas" were within the scope of the audit committee's remit from the beginning. It was identified in the January 1994 draft remit prepared by Ranson. But, until 1996, the committee's responsibility for 'major judgemental areas' was constricted to the context of the reports and accounts. Excluded from its remit were, for example, the actuarial valuation of liabilities, both generally and in relation to the regulatory returns; areas relating to the regulatory returns generally such as solvency; the use and importance of future profits and other implicit items; assets valuation, and the identification and valuation of inadmissible items. Product development and the reserving implications of product guarantees were also not within the remit.

145. There is no record of any discussion of the regulatory returns by the audit committee minutes in 1994. In June 1995 there was a detailed explanation by Headdon on the importance of form 9, and some detailed discussions on future profits for the first time. The link between the DTI returns and the statutory accounts was explored. It appears from the record that the committee asked questions about the process involved, and that Ranson or Headdon gave explanations. There is no evidence of challenge of the solvency margin, nor of the decision to use of future profits as a means of supporting solvency. One has the impression of a process of education of the committee members in respect of the mechanics of the regulatory returns and the decisions that had been made. Typical of the references was the minute:

> "A question about the purpose and use of the returns to the DTI led to explanations concerning the search for trends and the alerting of the DTI to any excessive level of guarantees or too rapid an expansion. The mechanics for questioning offices on their returns was outlined by Roy Ranson".

146. At the June 1995 meeting, Martin asked how the directors were, in reality, to sign the certificates required of them for regulatory purposes in a secure way. The committee was advised that comfort could be gained from:

i. the auditors' involvement which involved their giving the opinions that the statutory accounts were 'true and fair' subject to certain conditions and that the directors' certificate had been properly prepared in accordance with the relevant regulations and was reasonably made;

ii. the professional and regulatory requirements laid on the appointed actuary; and,

iii. the recognition of allowable delegation under company law to those properly qualified.

In relation to schedule 4, the valuation report by the appointed actuary, it was pointed out that the schedule was the personal responsibility of the appointed actuary. However, the 'true and fair' assessment by the auditors had for the first time brought in an element of independent checking of the appointed actuary's report and input. These assurances appear to have satisfied the committee.

147. In 1996 the remit of the committee was extended to include the regulatory returns. Thereafter, major issues relating to the regulatory position did arise, but the committee's role remained limited. The committee was not asked for its opinion on issues arising, such as the Society's solvency margin, or the use of future profits. From the minutes it appears that the committee asked relevant questions. The responses from Ranson and Headdon provided explanations of the processes involved, rather than justification of the decisions made in those respects. I have found it instructive to consider the approach adopted to the discussion of these in 1995 and 1996. The actuarial valuation of the liabilities of the office, the use of implicit items for future profits and zillmerisation, and the use of subordinated debt were all areas of potential interest in the case of Equitable, and could have provided focal points for the audit committee's examination of liability valuation over critical periods of the Society's history.

148. In March 1996, the committee concentrated on the report and accounts. The regulatory returns were discussed at the meeting on 12 June 1996. Headdon provided a commentary on the returns that set out a considerable amount of detailed information on selected items. Form 9 was described in some detail. He brought out the net assets position of the Society on the regulatory basis and discussed solvency and the use of the implicit profit items. He discussed the use of derivatives and their treatment in the returns. He discussed the revenue returns and the claims reflected in the appropriate form. He explained, in relation to valuation:

> "The importance of form 45 showing the income yield on various asset types was stressed. It was noted that these yields govern the discount rates used for valuation of liabilities and that the overall figure of 5.15% was probably slightly higher than that of some other companies due to the higher proportion of gilts held by the Society."

However, in relation to schedule 4, the appointed actuary's report on the liability valuation, he reported, consistently with the comments made in 1995:

> "This whole schedule setting out in much detail a report on the valuation was noted to be the responsibility of the Actuary of the Society, not that of the Directors."

This was to be a theme of reporting that was apparently accepted by the committee. Although the audit committee was not given the opportunity or information they would have needed properly to assess the judgments reflected in schedule 4, its members were told that it contained statements related to the business and valuation results. At the material time the appointed actuary had responsibility for the content and accuracy of schedule 4 of the return in a question with regulatory authorities, and a wider responsibility to his profession. But the fact that he had a professional and statutory responsibility for the schedule did not exclude the material it contained from the legitimate interest of the audit committee, nor his

responsibility for that material to his employers. In this, as in other areas, the actuary's external duties were conflated into an exclusive 'ownership' of the document and the information it contained, despite the directors' general responsibility for the financial affairs of the Society. and their obligations under the regulations to complete the required certificates. It is not clear on what basis the appointed actuary's duties to the regulator affected his duty to the Board and its committee to explain the basis on which the liabilities had been valued, from which he calculated the surplus available for distribution.

149. A similarly disjointed approach appeared in relation to investment. Ranson intervened in Driscoll's presentation to comment on the importance of the responsibilities of the audit committee being kept separate from the role and responsibilities of management, as he saw it. The chairman responded by expressing the importance of the extent of all kinds of risk being clear to the audit committee in accordance with its wide remit.

150. Headdon's presentation and Ranson's intervention illustrated an approach that had a common base: the executive of the Society acted on the basis that there were aspects of management that were outwith the scope of the audit committee's remit. In particular, this extended to the core valuation of the Society's long-term liabilities. The account of developing pressure from members of the committee for more information on risk reflected increasing discomfort. But at this stage in 1996 the management position was accepted by the committee. The position was the same in 1997. The committee was told that schedules 4 and 6 were the responsibility of the appointed actuary.

151. Tritton's general view was expressed by him in interview as follows::

> "... There was at the top the Appointed Actuary and his team of actuaries. Then there were the executive directors, all of whom, bar one, were actuaries: then there was the Senior Risk Management Group consisting of senior executives; then there was the Chief Accountant and his Department; then there were the Auditors who had actuarial partners; then there were the Regulators, the Government Actuary Department. And then there were also the lawyers, Denton. None of these ever expressed to me as a non-executive Director any concern as to the financial condition of the Society until 1998 when the GAR problem arose."

Martin's view, when asked what his understanding was as to how the liabilities were valued, was similar. He did not consider it the audit committee's duty to look at the valuation of liabilities. This was rightly left to the experts:

> "The Board properly regarded the valuation of liabilities as being within the sole ambit of the Appointed Actuary and his people. We had no actuarial expertise and could not be expected to have any. It was entirely his expertise...As I saw it, the non-executives were more responsible for assets than liabilities, but, of course, the whole board was responsible for the whole business but with experts having expert professional responsibilities we all respected."

152. Hirst's comments were to the same effect:

> "Schedule 4 was considered to be the sole responsibility of the Appointed Actuary. There was no discussion of this in the Audit Committee meetings or at the Board meetings (when the statutory report went to the Board without being seen by the Audit Committee). The Audit Committee and the Board appeared to accept that Schedule 4 was the responsibility of the Appointed Actuary and did not appear to challenge either RHR [Roy Ranson] or CPH [Chris Headdon] on this matter..."

153. Bowley's comments to the inquiry suggested that the committee's interests in detail grew with time. . It was provided, in his view, with more information than in most offices. The executive made more effort to explain matters. He could not say

whether the non-executive members picked up the explanations. It is my impression from wider discussions that the executive may indeed have provided more information to the audit committee and the Board than was provided in other offices. But the non-executive directors would have been better served by less, and more focused information, adapted to ensuring that they were instructed on the issues arising in relation to the decisions they had to make.

154. The pattern of the committee's business in 1998 was similar to that in 1997. The returns to HM Treasury were presented. Headdon described the purpose of the returns as being:

> "... to provide evidence of proper records being maintained by the company to enable the returns to be made, to provide data about the insurance industry and an indication of trends of a particular company compared with the industry. The Government Actuary's department also considered the returns and were principally concerned in ensuring that the companies were exercising prudent reserving."

He reminded the committee that "responsibility for relevant parts of the returns remained with the Board".

155. The returns had changed little from the previous year apart from two items: the subordinated debt and an explicit resilience reserve. Explanations were given. There was no record of discussion. Again schedule 4 was said to be the responsibility of the appointed actuary. The committee was taken through the notes, in particular those referring to the section 68 orders, allowing the Society to include a future profits item on its return, and allowing the Society to disregard its subordinated debt liability for the purposes of form 9 solvency. It is not recorded whether the prudence of the section 68 orders was discussed. There is no record of any questions whether the future profits item was based on reasonable assumptions, or how and when the Society intended to repay its subordinated loan. Tritton told the inquiry that he was concerned about the use of future profits, but he felt constrained from criticising this as it had been allowed by the regulators:

> "My main concern however arose with regard to future profits. The regulators accepted this as presumably normal practice, but to me for the Society to need to take future profits on its business to bolster its solvency position, pointed to some weakness in that position. What would happen, if for any reason, future profits began to dry up? I did not accept this as sensible regulatory practice, but it was allowed and upper limit figures were set for this practice. However the Society kept its future profits figure some way below that allowed by the regulators, on the basis that full utilisation could have been construed as a sign of weakness."

156. By 1999 the committee was deeply involved in discussions related to the annuity guarantee issue. The committee first discussed the guaranteed annuity rates on 24 February 1999 at a special meeting to discuss reserving and disclosure. Headdon put forward four different levels at which the additional liability arising from the GARs could be assessed. The levels were those already discussed, ranging from a commercial cost of £50m, to the level implied by the FSA guidance, which would amount to a liability of £1.8 billion. The derivation of the values was discussed. In 1999, the executive failed to present the statutory returns to the audit committee for review prior to the Board. This was said by Headdon to be "due to the early submission of the returns that year".

157. The audit committee do not appear to have been asked to consider whether or not the GAR provisions were appropriate. They were, however, clearly told that Ernst & Young could agree with the reserve for the commercial cost, and for the Companies Act accounts. In relation to the latter, the committee were told that:

> "... this amount was derived by assuming a £15% take up of guarantees on the main relevant classes of business. This was a prudent basis, considering that the current rate of take-up was between 1% and 1½ %."

The committee were told further that "this did not impede the Board's bonus decisions". They were not asked to consider whether the Board's bonus decisions remained appropriate; they were not given any information on which to base any such questions. They did, however, consider whether there would need to be disclosure in the report and accounts of a material contingent liability in respect of the GARs. The committee decided such disclosure was not necessary, based on the "strong legal opinion that the Society's directors had acted entirely properly and within their powers in adopting the system of final bonus additions".

158. It is not possible to tell the amount of time spent discussing and debating the GAR provisions, nor to tell whether the committee's views were wholly prompted by the executive or not. The audit committee met again on 9 March 1999. The GAR reserving issue was raised once more, but only for Paul McNamara of Ernst & Young to comment that further work had been undertaken since the last meeting "in connection with the appropriate provision to be made". The audit committee had clearly not been involved, and the only comment recorded was that of Headdon, who told the committee that the £200m provision for the technical reserves had been supported by Ernst & Young.

159. On 12 October 1999 the audit committee was told of the key areas of the audit focus, which include GARs, actuarial valuation and strains on solvency but there was no response recorded from the committee, apart from a discussion on the GAD reserving guidance for the GARs and the fact that these were not likely to be relaxed. The rest of the meeting discussed risk, which is addressed separately in this chapter.

160. On 7 March 2000, the audit committee was told that it was proposed by management that the provision for the GARs should remain at £200m in the 1999 accounts, as in 1998. Paul McNamara told the committee that Ernst & Young had reviewed the new actuarial valuation process and had no issues to raise in this regard, having been satisfied that the appointed actuary's approach had been reasonable, including the monitoring of the Society's solvency position

161. The regulatory returns were presented to the audit committee and next considered on 7 March 2000. The committee was told by Headdon that there were no changes to the regulations, that GAD had issued further guidance on reserving for GARs and that this was reflected in the returns. Leaving aside the GAR issue, the regulatory position presented by Ruth Loseby followed the established pattern. She gave a précis of the main features of the returns. It was remarkably similar to earlier years the committee was told schedules 1 and 3 were subject to audit and the direct responsibility of directors; schedule 4 was the personal responsibility of the appointed actuary, and the directors responsibility in this matter was limited to ensuring it was prepared. Following this précis, the audit committee approved the returns. They were not asked to take decisions on the substance of the returns.

162. At no time, throughout the period from 1994 until 2000, did the audit committee consider in any detail the assumptions on which the liability valuation was based, not did it concern itself with the basis or justification for the actuarial assessment of the liabilities. With the benefit of hindsight, Tritton told the inquiry that he thought it would have been helpful to the non-executives if there had been a liabilities committee as well as an investment committee. That may be the case: a committee dedicated to the liability valuation might have focused more particularly on critical areas. But the liability valuation was an issue for the committee for statutory accounting purposes from the outset, and for regulatory purposes from 1996. The position appears to be that the committee was totally dependent on the actuaries for advice on what was material as well as advice on the solution of any problems that arose.

163. Indirect involvement with liability valuation, as a source of business risk, was also beyond the scope of the committee's initial remit. As discussed above, the audit committee did not have a direct role in risk management. When the committee was established, at the start of 1994, there were no conventional risk management

systems in place. There were changes in the committee's remit in 1996 and 2000, but these did not specifically entitle the audit committee to look at risk. In 1996, the remit was extended to include review of internal control, and in 2000, the terms of reference were altered to specify that the audit committee should receive reports from the risk management group and should have an overall review of risk in relation to the report and accounts and other general matters.

164. The steps taken by Tritton and Davis to gain some information and control over the issue of risk management have been discussed. Over most of the period, instead of risk being a legitimate review topic for the audit committee, the executive retained control by making the responsibility for risk an executive matter, and formed exclusively executive committees to deal with it. These included the SCRG, the ICRT, and the RMG. These groups reported to the audit committee on an annual basis. There was a risk review in late 1998 by Ernst and Young and in early 2000 the RMG evolved into the business risk management group (BRMG) and the internal audit function.

165. The internal control functions that existed in the early 1990s did not extend to actuarial management of the Society. So far as they were in force, they were regarded as within the responsibility of senior management rather than the Board and its committees, and as a tool to monitor compliance with management systems. The risk of mis-judgement in assessing the assets and liabilities was not considered a control issue. In that context, the control function was limited to checking the existence of the items and that they were recorded at the correct amounts. Bowley's five principles of operational control, ("authorisation, recording, safeguarding, reconciliation, and valuation"), were the criteria the systems had to meet. There was no requirement to demonstrate compliance with defined business objectives. The Society was criticised by Ernst & Young in 1997 and 1999 for failing to operate risk management programmes from clear business objectives.

166. Periodic valuation of assets and liabilities was reviewed mechanistically rather than as a matter of substance, ensuring that recorded values met legislative and regulatory requirements and that errors and irregularities were detected. The actuaries' judgment on values was not subject to review.

167. In October 1997 the audit committee received the first annual report on internal control. The self-assessment exercise was described. It relied on the managers' own assessment of the system of controls under which they operated. The report was then reviewed by the SCRG, which reviewed "the adequacy of the controls stated". The review was entirely reliant on the managers' assessment: the SCRG did not undertake any independent analysis of the controls described. This was made explicit to the audit committee:

> "It was stressed that the review by the SCRG did not attempt to test the actual responses made".

Dependence on management in undertaking the risk assessment was justified on the basis that:

> "the review indicated that the self assessment exercise had been undertaken diligently by managers".

168. Examination of the risk list, in its several editions, revealed a pre-occupation with systems and data recording as tools for managing risk. Item 19, the valuation of liabilities, stated that risk lay in the possibility of incorrect data being recorded, leading to incorrect valuation. The valuation process was not identified as creating risk. Section 22, "guarantees which become onerous to the Society" focused on modern contracts, and made no mention of guaranteed explicit or implicit in older in-force business. It was not until 1998 that liability valuation and product risks (which included guarantees) came under review.

External Guidance

DTI Guidance on Governance

169. The Insurance Companies (Third Insurance Directives) Regulations 1994[19] amended the Insurance Companies Act 1982 inter alia to introduce amendments to the regulatory powers of intervention to include power to take action to ensure that the criterion of sound and prudent management was fulfilled[20]. The provisions came into force on 1 July 1994.

170. On 1 December 1994 the DTI wrote to all chief executives of authorised insurance companies drawing attention to the new power, and to implications for directors' certificates on regulatory returns. Two types of guidance were offered: 'systems of control' and 'preparation of returns'. For present purposes the former is relevant. The letter referred to a 'Systems of Control' series of guidance documents intended to set out the department's views on the issues to be taken into account in setting up and maintaining control systems. It was not intended to prescribe rules for the design of systems.

171. The letter enclosed a copy of Prudential Guidance Note 1994/6, effective in respect of financial years starting on or after 1 January 1995, and the first in the series of 'Systems of Control' guidance notes, dealing with investments and counterparty exposure. It referred to the explicit requirement in the Act, following implementation of the third insurance directives that companies be managed "in accordance with the principles of sound and prudent management". The criteria were set out in schedule 2A to the Act and included in paragraph 6(l)(b) of the schedule the statement that:

> "The insurance company shall not be regarded as conducting its business in a sound and prudent manner unless it maintains adequate systems of control over its business and records."

The aim of "systems of control" guidance notes was to set out the issues which DTI believed it was important for directors to consider when setting up control systems. Compliance with the guidance was not compulsory. However, it was compulsory for directors to put in place adequate systems of control.

172. The 'Systems of Control' guidance emphasised that suitable control and management information systems should be in place to enable the company to implement an appropriate investment strategy, having regard to the statutory framework and any prudential guidance issued or endorsed by the DTI. It was emphasised that:

> "19. In order to satisfy themselves that investment activity is carried out in accordance with the approved strategy and that adequate controls are in place, the Board of Directors will need to receive reports at an appropriate frequency with appropriate details as to the investment activities and controls."

173. The management of the Society prepared a response, dealing primarily with investment. In it they said:

> "Investment strategy is determined by the Investment Committee within the broad parameters laid down by the Board. That Committee currently comprises four non-executive Directors, including the President and two Vice-Presidents, the Managing Director and the General Manager - Investments. It is also common to invite some Senior Investment and Property managers to attend the meetings. The Committee's function is in part an active policy setting-decision making body and in part a monitoring body. All Committee agenda papers are sent to all Directors of the Society. Minutes of the meetings are included in the agenda papers for the Board meeting immediately following the Investment Committee meeting, and thus are sent to all Directors.

[19] SI 1994/1696.

[20] Section 45(1)(b) of the Insurance Companies Act 1982.

> The Committee meets monthly, at which time it would discuss, and set, general investment strategies, and receive various standard and one-off reports, usually from Investment Managers."

174. In relation to actuarial advice, the report stated:

> "The Appointed Actuary reports formally to the Board on actuarial considerations affecting investment policy at least annually. Revenue data is reported monthly with a more formal quarterly review. The quarterly reviews include an updated assessment of any considerations affecting investment policy. The Board is then able, taking account of the advice of the Appointed Actuary, to set broad guidelines within which the Investment Committee should determine investment strategy.
>
> The present Appointed Actuary is a member of the Investment Committee of the Board and participates in the formulation of investment policy. During the time before he was a director, he attended meetings of the Investment Committee and so was able to comment on the proposed investment policy as it was formulated. Future Appointed Actuaries may not, however, be members of the Investment Committee, but will nevertheless be invited to attend and participate in the meetings."

175. Detailed discussion of the Society's governance arrangements relating to investment were then set out. It was said that the management of the Society's investments was at all material times carried out within the terms of the report. Investment judgments might be good or bad: there was market risk that could not be eliminated.

176. The 1994 provisions, and the guidance issued by DTI, focused the attention of boards and management formally on the over-arching responsibility of the directors of offices for the management of the business and for control of operations. But there had already been a general movement in that direction, and the Equitable Board had been pressing for change in the Society's governance that would increase the effective supervision it exercised over management. In 1994 the process was slowly beginning, from a base level at which for all practical purposes control of risk relating to the Society's products and liabilities had been vested exclusively in an executive management that was particularly resistant to change.

177. In terms of systems, the Society's investment procedures appear to have been well-established and appropriate. For present purposes they presented a marked contrast to the management of liability-related risk. The control of investment activity provides a model against which to assess the effectiveness of control of liabilities and product design. The Society did not, at any material time, have an equivalent system of controls over the actuarial function.

The Smith Report

178. Sir Robert Smith's report on audit committees sets out a modern model. It would not be appropriate to apply it as a test of the arrangements made by Equitable at any material time. But it indicates that in 2000 Equitable was approaching a standard of provision that was within striking distance of the Smith model of an effective audit committee. Its roles and responsibilities in relation to financial reporting covered changes in accounting policies and practices; major judgmental areas; significant adjustments arising from audit; the going concern assumption (though that was never a matter for serious consideration); compliance with accounting standards and compliance with legal standards. Risk management systems and internal financial controls were in place. Internal audit, in a modern edition, was under development. Communication with policyholders (the nearest equivalent to shareholders in the Smith model) was being addressed. Procedures and remuneration and other particular issues were already covered. Whistle-blowing was not adequately covered. But that presented the Society with particular difficulties in the most relevant area; the work of the actuarial department. The appointed actuary was under an obligation to report to the regulator if

circumstances demanded it. But other actuaries, including those on the Board, were inhibited by professional rules from undermining the authority of the appointed actuary.

179. The Society's extensive revision of its systems in 1999 and 2000, and the approach adopted then is perhaps the best measure of what had been required over a considerable period of time, and what could be achieved with reasonable expedition when there was a will. The report by Ernst & Young on risk management was received in the autumn of 1998. By early to mid 1999 it was agreed that a risk function, including an internal audit team, should be formed. The practical implementation of the proposals sets the context. Managers and staff were briefed in September 1999. The SCRG was disbanded in the autumn of 1999. In the autumn of 1999 recruitment began for a replacement for Hirst as assistant general manager. Hirst also began recruiting a professional internal auditor. He recruited Mike Davies from Royal Bank of Scotland, who joined in May 2000. Hirst's own replacement as AGM for accounting and financial control arrived in June 2000. The new risk function began operating in January 2000, when Soundy began reporting to Hirst.

180. The domestic solution developed by the Society in 2000 with the assistance of Ernst & Young was ample. Subject to reflecting generally accepted contemporary views, there appears to be no reason why the Society could not have developed a comprehensive audit committee function and associated internal audit at any time during the 1990s had there been the will so to do. It appears that the lack of progress towards that end can only be attributed to the intransigent resistance of the executive to what was regarded as an attempt by the Board, or particular members of it, to encroach on what had come to be regarded as management's exclusive area of interest. Having regard to the articles of association, the notion that delegation to the executive could ever be exclusive of the continuing supervision of the Board, and to recall should that course seem appropriate, was at all times wholly without foundation.

181. In retrospect, the conduct of the Society's audit committee would not have satisfied the criteria set out by Sir Robert Smith. One could hardly characterise the demand for a risk list and an active part in risk management as a 'robust stance'. The committee did receive information that there was a proper system of oversight and allocation of responsibilities for day to day monitoring of financial responsibilities. In many operational areas there was. But in relation to actuarial judgment, which was fundamental to stability of the business, there was not. Induction training does not appear to have extended to providing directors with a proper understanding of the dividing lines between the technical actuarial area and the exercise of discretionary powers dependent on that technical material. It appears to have been a particular conceit of the actuaries that the exercise of discretion was as much their exclusive preserve as the arithmetic that instructed it. In general it is the defining characteristic of an expert that he or she can communicate the results of his or her expertise with sufficient clarity to enable any reasonably intelligent person vested with a decision making power effectively to exercise that power. Actuaries need not be in an exceptional position in this respect, and life offices' boards can be as competent as others to reach decisions on the basis of intelligible advice.

182. However, in general the assertion of actuarial control over critical areas of the Society's business was consistent with the approach that had been adopted over time. And it can be illustrated by reference to two matters within the actuarial management area of activity.

The Actuarial Functions

Product Design

183. In *With Profits Without Mystery*, the authors referred to actuarial involvement in product design, and its relationship to benefits. The structure of the benefits

provided by the Society's products was said to require the actuary to have a close involvement, and interest, in the marketing aspects of the business. It was said that the Society's actuaries would not regard as helpful an environment in which the actuarial involvement in product design was limited to narrow technical matters.

184. The rationale for actuarial involvement in product design, for the classes of business written by the Society, was made plain to the profession. In practical terms it was realised in almost total control over product design. In terms of governance, the issue was not whether actuaries should be involved in these areas. It was whether they should have control over the relevant areas to the exclusion of practical involvement of the Board. The Board papers contain repeated references to amended and to new products as events in the past. The extent of delegation of product design was illustrated in discussions in 1993. The Society had launched a new 'dread disease' product. On 22 September 1993 a question was asked about the product at a meeting of the Board. The minutes recorded that Ranson had indicated that the newly launched dread disease product was not seen as a material change in risk-taking especially as 50% of the risk was reassured. He also referred to the managed annuity product that had been launched. The Board 'noted' that there had been a press conference. Of the two products, the managed annuity was to prove difficult: the Inland Revenue required it to be withdrawn. Both products had been introduced without Board approval.

185. The same products were discussed again at a board meeting on 24 November 1993. Ranson said that the new products were within the normal format of the Society's business. The general manager for sales and marketing (Shaun Kinnis) assured the Board that the Society's core business would remain pensions, while meeting the obligation to offer a comprehensive range of products. Ranson undertook to consider the appropriate method to involve the Board in product design.

186. On 22 December 1993, the Board minutes record under the heading of "Principles of Operation of the Society":

> "The Managing Director and Actuary drew attention to the fundamental principles of the operation of the business and reminded the Board how the Executive Management operates to develop new products. A Director explained his perception of the critical illness contract and while seeing that as only a marginally different form of contract, considered that it does take the Society into a particular form of illness insurance. He suggested that external perception should be considered when determining whether or not a new contract involves a move into a new field.
>
> It was accepted that a move to a sickness (PHI) contract would certainly be a new field of operation for various reasons and the Managing Director and Actuary confirmed that such a contract as that would be presented to the Board if that kind of material move were to be proposed. However, for marginal moves of contract type, it was suggested that the Managing Director and Actuary should check with the President and that was agreed."

The director raising the question was Sherlock, by this stage a non-executive director of the Society.

187. Notwithstanding Sherlock's intervention, the Board made little progress in achieving a practical say in product development. The Board apparently accepted that whether or not it received information about new product proposals would depend, in the first place, on the actuary's view whether it involved a move into a new field, and in the second place, and in marginal cases only, on a discussion between the actuary and the president. The Society's business development was related to the production of innovative contracts appropriate to the requirements of its narrowly defined target market. The delegation of product design was all but comprehensive. As the discussion in *With Profits Without Mystery* indicated, there was a close relationship between product design and liabilities. The risks to which

the Society was exposed from time to time included product design risks, and of these, the Board was ill-informed.

Liability recognition and valuation

188. From 1973 onwards the actuaries presented extensive reports to the Board on the technicalities of liability valuation. For most of the relevant period it has been difficult to determine how and when important decisions about the Society's financial position were made. Particularly in the 1970s and 1980s minutes were brief and uninformative, and there is little or no evidence of any substantial discussion. The agenda remained largely unchanged and included some surprising items for a Board, such as the allocation of marriage bonuses, alongside what might have been expected to be more relevant and substantial issues. In the 1990s minutes were more full. But they still failed to record in any detail the background to more important changes in the business. Reports on liability valuation were formulaic, with the same headings being presented repeatedly with updated figures. There was relatively little background information on the reasons for particular actions or approaches. The valuation reports tended to be long, but lacked analysis and guidance on the decisions required of the Board. There is very little evidence of challenge.

189. In the early 1990s changes in GN1 required the appointed actuary to discuss with the Board the future financial position of the office. This does not appear to have happened on a regular basis until the later 1990s. In particular there does not appear to have been structured exploration of the future financial position of the Society on different scenarios. A combination of a low capital base, rapid expansion and continuing and potentially onerous guarantees would have made some relatively sophisticated modelling appropriate. There were well-developed stochastic techniques available throughout the 1990s. None was employed.

190. The extent of actuarial control over liabilities was illustrated late in the reference period. In July 1999 the Society and its legal advisers were engaged in preparations for the continuing *Hyman* litigation. The Society's solicitor commented on the need to establish a "paper trail" in relation to the Society's approach to the determination of surrender values and how this was documented and communicated. Headdon responded that the Board had delegated to him, as the appointed actuary, a unilateral power to determine surrender values. He said that he would probably mention a decision to apply a market value adjustment informally to Nash, but if Nash was on holiday or unavailable, he would apply the MVA anyway. He asserted that under GN1 surrender values had to be determined by the appointed actuary, though he did not point to any provision that in his view had such an effect.

191. A similar issue arose on 3 July 2000 in the context of transfer values. A particularly telling example of the actuaries' approach, already discussed at some length, was the treatment of the differential terminal bonus policy that led to the *Hyman* litigation. In December 1993 the board resolved to alter the formal statement of bonus that had been approved in February of that year: a matter within the exclusive competence of the Board. But, so far as the records of the Board's business disclose, there was never a decision to adopt the policy that was reflected in the statement, or any exploration of the potential guaranteed annuity rate problem and its possible implications, despite the evidence that within the actuarial team the 'solution' to the problem had been formulated as long ago as 1982-83. This was consistent with the view that the determination of the sums payable on policies was a matter that had been delegated to the actuaries to the effective exclusion of the Board.

192. The guaranteed annuity rate issue demonstrates the Board's dependence on the Society's actuaries for information and advice on the valuation of liabilities and the amount of the long-term fund. To a considerable extent that dependence was unavoidable: these are the specific areas of professional responsibility that one would expect to be treated as within the scope of the actuaries' duties to the Board.

The question whether the dependency was so extensive as to amount to total abrogation of the board's responsibility for this area of work is not within my remit. A full disclosure of the annuity guarantee risk was made only when the problem became public in 1998.

Conclusions

193. The Higgs report emphasised the need to avoid a "one rule fits all" approach to corporate governance. The peculiar characteristics of the mutual life office emphasise the need for adaptation of any general rule to fit the demands of this business form. However, it goes further than that. The emphasis on the over-arching role of the company's constitution generally has particular relevance and importance in the case of the mutual life office. Many such companies have constitutional histories that reflect their origins, age, general conservatism in constitutional matters, and their adherence to ideas believed to have been inherited from the past. In this chapter the corporate governance of Equitable has been discussed: the Society may have been unique, however, and one would be slow to infer that there were or are general deficiencies based on this particular example. However, what the Society's position illustrates is what could happen, over a particular period and in particular circumstances, and what existing systems of corporate governance accommodated in the case of the Society.

194. The position reached in 2000 in the development of the Society's corporate governance systems was not perfect. It would be difficult to say that risk management had fully 'come of age'. Hirst told the inquiry what was covered. He said that the scope of the risk function covered strategic and operational risk, but not credit risk or actuarial risk (such as looking at liabilities). It did look at operational risk within the actuarial functions, that is the operational risk to the achievement of the actuarial functions' objectives. For example, how it would affect those functions and the achievement of their objectives if they lost key staff members. The loss of key staff would have had a related impact on the carrying out a critical function such as liability valuation. Whilst the function reported to him, there was no internal audit review of the actuarial function or the process for determining actuarial liabilities. He thought that if the internal audit function been in existence for longer, some review of the systems and procedures in the actuarial areas might well have been appropriate. But internal audit was only formed in May 2000. Only Ernst & Young took an interest in the actuarial function. Hirst's role in relation to risk management was to develop a methodology and to help in its implementation across the business. Individual risks remained the responsibility of department managers. He would help them with risk identification, evaluation of potential likelihood and impact, action planning, and monitoring to ensure that agreed actions were taken.

195. These developments involved radical changes in the management of risk within the Society. They represent a victory of modern management thought over entrenched opposition to change. In a real sense the new systems provide a measure of the deficiencies in the management systems they superseded. However, it appears reasonable to observe that even by 2000 it was not thought to be a practical proposition that actuarial risk should be monitored and managed. The guaranteed annuity problems, the over-allocation of bonus, and the manipulation of the impact of regulatory solvency by changed product design and by modification of actuarial assumptions in liability valuation would not have been identified at the stage that by then had been reached. Unless Hirst was correct in anticipating further change, these risks would have remained exclusively in the actuarial area, without independent management scrutiny. But there was, overall, a much more acceptable governance system in place internally, largely as a result of the need to respond to external pressures.

196. There is, however, nothing in the structure of a mutual life office to prevent a similar problem emerging. In the case of a proprietary office the market can exercise

considerable influence on management. Bancassurance and similar complex integrated financial services providers may break down the direct link between management of the life business and shareholder response. But it can reasonably be assumed that market forces will, in appropriate circumstances, react to management failure and, directly or indirectly, affect the sustainability of current policies. In a mutual with-profits office, the policyholders effectively enter into a joint venture with the equity shareholders, sharing in the profits and losses of the long-term business activity. If shareholders intervene in management in their own interests, the policyholders' interests are affected and will normally be taken into account. Regulators have been diligent to prevent shareholder interests being preferred disproportionately over those of policyholders in the past, and it is reasonable to believe that under the current regime that requires fair treatment of policyholders a similar approach would be adopted.

197. There is no external interest that can be relied on to protect the interests of policyholders of a mutual life office, and the policyholders themselves, though representing the proprietary interest in the organisation, are powerless. However, the mutual office has its foundations in contract, typically constituted by the articles of association of the society and the individual policies of its with-profits members. An acceptable statutory innovation on that contractual basis that would provide direct protection against management policy is difficult to imagine. It might be possible to provide for periodical review of the continuing acceptability of mutual status by requiring a poll of members. But the rigidity of any such provision would expose individual societies to chance, possibly wholly unrelated to any factor reflecting on the existing management or on current members' interests.

198. I have come to the view that the only acceptable approach to the many, and unpredictable, issues that are peculiar to the mutual life office is to ensure that they are subject to a level of regulatory scrutiny that takes account of the reality that, apart from the regulator, there is no-one who can intervene effectively to influence the activities of what must remain a form of organisation managed by a self-perpetuating oligarchy, selected on an unaccountable basis by current directors as their successors in office, and vulnerable to the influence and, in an extreme case, control of professional actuaries who are answerable, if at all, only to those same directors who are fundamentally dependent on their advice.

CHAPTER 10: ACCOUNTING FOR TERMINAL BONUS

1. The pattern and amounts of payments made by the Society as terminal, or later final, bonus have been described. Later I shall comment on the question of policyholders' reasonable expectations in relation to the continued payment of terminal bonus values in the absence of a material change in the Society's financial position and market volatility. In this chapter, I shall discuss the legislative and regulatory background against which the Society accounted for these payments on a cash basis and focus on the question whether there was any requirement that the Society should have accrued for or otherwise acknowledged terminal/final bonus in the Companies Act (statutory) accounts or regulatory returns. The discussion is relevant to the audit of the Society's financial statements and to regulation.

Legislative Background

2. Statutory protection of purchasers of life assurance products has a long history, anticipating by many decades the introduction of more general consumer protection legislation. In some respects the existence of a specific code may have inhibited the development of the regulatory and accounting requirements applicable to life business in parallel with developments in the wider business context, so that the particular protective provisions fell behind more general developments. In that respect, life business would not be unique: familiarity with an existing prescribed code may generate a complacency that becomes a powerful defensive barrier against change. The risk may be related to the degree of specialisation involved. The more narrowly focused and specialised the area of business, the more likely the participants are to regard established practices as sufficient, if not already over-prescriptive. A period of general commercial success, avoiding financial disaster, can easily persuade responsible officers that regulation is unnecessarily restrictive of management freedom.

3. The Life Assurance Act 1870 was enacted as a measure to protect policyholders after an unprecedented level of insolvency of life insurers, and required inter alia:

i. The establishment of a separate long-term fund;

ii. An actuarial investigation of the long-term fund every five years; and

iii. The preparation of a revenue account and balance sheet each year in a prescribed form to be filed with the Board of Trade[1].

The fundamental elements of the current regulatory regime, now characterised as the segregation of funds, the statutory functions of the actuary, and the requirement for filing a regulatory return, were introduced in these early provisions. In current form, the regulatory returns must be supported by certificates by an appointed actuary, the directors and the auditor. The requirement to carry out an actuarial investigation every five years changed to three years and then, under the Insurance Companies Act 1982, became annual. The returns were made to the regulatory body charged with the relevant statutory duties at the time, and that, for most of the relevant period, was the Department of Trade & Industry (DTI). The returns were available to the public and were the basis of the regulatory philosophy of 'freedom with disclosure' whereby life offices had a degree of discretion over the basis on which the returns were prepared, but were subject to such discipline as commentators and the markets might apply.

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[1] Responsibility for this aspect of regulation rested with the Board of Trade up to 1970, the Department of Trade & Industry 1970-74, the Department of Trade 1974-83, the Department of Trade & Industry from 1983 to transfer of functions to HM Treasury on 1 January 1999. Responsibility was delegated to the Financial Services Authority (FSA) from 1999 to November 2001, and became the FSA's statutory responsibility from 1 December 2001 under the Financial Services and Markets Act 2000.

4. The earliest material statute for present purposes was the Insurance Companies Act 1982 ('1982 Act'). It contained the powers and duties of the regulator and prescribed the regulatory process.[2]

Valuation and Solvency, and Reporting Rules

5. Over the reference period there were numerous editions of regulations relating to the valuation of the assets and liabilities of insurance companies and to the preparation and submission of accounts and statements for regulatory purposes. These successively set out rules regarding the recognition and valuation of assets, and the principles for recognising and valuing liabilities, and prescribed the form of the accounts to be included in returns, certificates to be appended to the accounts and other matters. Some provisions, such as Regulation 2 of the Insurance Companies (Accounts and Forms) Regulations 1968 (which explain the role of the auditor as understood in the early 1970s), are dealt with in context where there is a particular point to be made. But in general I have taken the view that an extended historical analysis of the regulations is not necessary. The period of greatest interest in the Society's financial affairs lay largely in the 1980s and 1990s, and it is the regulatory structure over that period that requires discussion. For present purposes, the Insurance Companies Regulations 1981[3] ('1981 regulations') and 1994[4] ('1994 regulations'), and the Insurance Companies (Accounts and Statements) Regulations 1983[5] and 1996[6] ('1983 accounts regulations' and '1996 accounts regulations') are material in relation to the valuation of assets and the principles for valuing liabilities, determining the required minimum margin of solvency, and presentation of the accounts.

Solvency Margins

6. Section 32 of the 1982 Act required all offices carrying on insurance business in the UK to maintain a margin of solvency. The amount prescribed was determined by the regulations in force from time to time. 'Admissible assets' only were taken into account for solvency purposes. The actual margin of solvency was the excess of admissible assets over liabilities, each element being determined in accordance with the applicable regulations. The regulations stipulated that companies had to maintain a "required minimum margin" ('RMM') of solvency for regulatory purposes, and prescribed rules for determining that value. The relevant rules set out in part II of the 1981 regulations and part IV of the 1994 regulations, differed from those applicable in the preparation of the statutory accounts, and different levels of solvency were derived from the application of the two sets of rules. Failure to meet the regulatory required minimum margin of solvency empowered the Regulator to request that the company submit and implement a plan for the restoration of a sound financial position.

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[2] The following sections of part II of the Act are relevant to this chapter:

- Section 17: *Annual accounts and balance sheets*. This required insurance companies to prepare annually a revenue account, balance sheet and profits and loss account.
- Section 18: *Periodic actuarial investigations of company with long-term business*. This provision obliged insurance companies carrying on long-term business to have an annual investigation into the financial condition of the business. The investigation comprised: a valuation of the long-term business liabilities of the office, a determination of the excess of assets over liabilities and a determination of the extent of the profits arise which were considered distributable to policyholders.
- Section 19: *Appointment of actuary by company with long-term business*. The investigations were to be performed by an appointed actuary.

[3] SI 1981/1654, 1 October 1982.

[4] SI 1994/1516, 1 July 1994.

[5] SI 1983/1811, 15 March 1984.

[6] SI 1996/943 (applicable to financial years ending on or after 23 December 1996).

Guarantee Fund: Minimum Margin

7. For long-term business, the insurer had to maintain a "guarantee fund," which was defined in regulation 9 and regulation 22 of the 1981 and 1994 regulations respectively, in the case of mutual companies, as the higher of:

i. One third of the required margin of solvency (provided that items which are not implicit items must cover the greater of the minimum guarantee fund and 50% of the guarantee fund); and

ii. The minimum guarantee fund (ECU 600,000 or approx. £400,000).

The required minimum margin of solvency, calculated in terms of the regulations applicable from time to time, had to be maintained throughout the year.

8. These provisions were aimed at supporting the prudential objective of ensuring that companies could and would meet relevant liabilities to policyholders. Given the nature and duration of life policies, the valuation of liabilities was a complex process requiring the application of actuarial principles and practices. Accordingly, it was a statutory[7] requirement that the liabilities valuation (the long-term business provision) should be performed by a specified officer, the office's appointed actuary. The work was performed during the actuary's annual investigation into the financial condition of the office's long-term business as required by the 1982 Act. This feature was unique and distinguished the accounting and reporting requirements imposed on an insurance company from those applying to general companies.

9. The computation of regulatory solvency required the valuation of the office's assets and of its liabilities, in accordance with the applicable regulations, namely those contained in parts V and VI of the 1981 regulations and parts VIII and IX of the 1994 regulations. The appointed actuary's statutory responsibility to the regulator did not extend to valuation of the assets. The directors' certificate under schedule 6 part I of the 1983 and 1996 regulations respectively had to state that the value of the admissible assets of the company had been maintained at not less than the amount of the liabilities of the business.

10. In addition to complying with the requirements of the regulations, the actuary had also to comply with guidance issued by the Institute and Faculty of Actuaries. This guidance, so far as mandatory, was contained principally in guidance note GN1, which set out the professional responsibilities and duties of the actuary and, in effect, extended the formal requirements of the 1982 Act and the related regulations in a number of areas, supplemented by GN8 which was not mandatory, but reflected best practice. From 1993 appointed actuaries had to state that GN1 and GN8 had been complied with[8]. The interaction of the actuarial valuations and their bases and general accounting requirements was of fundamental importance.

11. The presentation of the Society's liabilities in its financial statements has to be assessed in relation to the various requirements imposed on the process of determining the liabilities. Topics of specific interest in the period from 1990 to 2000, which is of particular interest to the inquiry, are:

i. Recognition of liabilities (Long-term business provision);

ii. Discounting of long-term liabilities;

iii. Contractual guarantees and options;

iv. Treatment of terminal/final bonus; and

v. Policyholders' reasonable expectations.

12. An actuarially determined long-term business provision was included in each of the statutory accounts and the regulatory returns. In the accounts, it was classified as the long-term business fund/technical provision. In the returns it was

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[7] Section 18 of the Insurance Companies Act 1982.

[8] For example, GN1, version 5, paragraph 4.1; and GN1, version 6, paragraph 2.6.

classified as the mathematical reserve. Different statutory and regulatory requirements, and different practices, applied in each case. In general the same base values were usually presented in each statement on the view that the statutory presentation could properly be taken to reflect the generally more prudent regulatory valuation. The statutory valuation would however exclude additional regulatory reserves such as resilience and other general reserves that would inflate the disclosed regulatory liability value. The assets valuation requirements of the regulatory return were not, however, replicated in the Companies Act accounts, and the overall regulatory position was therefore expected to be more prudent.

13. For returns purposes, section 18 of the 1982 Act[9] applied. The appointed actuary was required, in terms of regulations, to compute the long-term business provision of a life insurance company, on the basis of recognised actuarial methods, with due regard to actuarial principles. Consequently the appointed actuary was required to value long-term liabilities in accordance with the requirements contained in the 1981 regulations, and the 1994 regulations which later superseded them, and to have regard to the assets valuation brought out on an application of the regulatory rules.

The Insurance Companies Regulations

14. The 1981[10] and 1994[11] regulations set out rules regarding the principles for valuating liabilities. Regulation 54 of the 1981 regulations: *long-term liabilities* provided:

> "The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before valuation date) shall be made on actuarial principles and shall make proper provision for all liabilities on prudent assumptions in regard to the relevant factors; and that amount shall in the aggregate not in any case be less then the amount calculated in accordance with regulations 55 to 64 below (which shall apply only to long term liabilities)."

15. The valuation principles reflected the net premium method: for normal annual premium contracts future premiums were taken into account to the extent appropriate to provide the specified benefits under the contract excluding future bonuses, with appropriate provision for expenses, acquisition expenses being subject to zillmerisation as appropriate, and subject to specified interest discount provisions. The long term-liabilities of the office were defined in regulation 50 of the 1981 regulations as:

> "liabilities of an insurance company arising under or in connection with contracts for long term business."

16. Regulation 52 provided that the amount of the long-term liabilities should be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies. In determining that amount all contingent and prospective liabilities had to be taken into account, but not liabilities in respect of share capital.

17. These provisions were concerned with quantification. There were no supplementary provisions to assist in the recognition of liabilities, and in particular none that was referable to policyholders' reasonable expectations. The valuation rules reflected the view that exclusion of the profit element from future premiums allowed for the future emergence of surplus and thereby secured policyholders' expectations of future bonuses.

18. In the 1994 regulations there was a material change of language. So far as relevant for present purposes, the definition of long-term liabilities in regulation 58

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[9] Section 18, Periodic actuarial investigation of company with long-term business.
[10] SI 1981/1654, 1 October 1982.
[11] SI 1994/1516, 1 July 1994.

of the 1994 Regulations was the same as in the 1981 regulations. But regulation 64 provided, inter alia:

> "(1) The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before the valuation date) shall be made on actuarial principles which have due regard to the reasonable expectations of policy holders and shall make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors.
>
> (2) The determination shall take account of all prospective liabilities as determined by the policy conditions for each existing contract, taking credit for premiums payable after the valuation date."

19. Neither the 1981 nor the 1994 regulations provided for the recognition of liabilities by reference to policyholders' reasonable expectations. The 1994 regulations made reference to policyholders' reasonable expectations. But the definition provision, defining liabilities in terms of liabilities arising 'under or in connection with' contracts, read with regulation 64(1) went no further than to required that, in the case of liabilities recognised in terms of regulation 58, quantification of the liability for the purposes of the returns was to take into account, inter alia, of policyholders' reasonable expectations. In Skerman's seminal paper on valuation[12], contractual liabilities were recognised: future bonus expectations were reflected in the net premium basis of valuation by limiting the future premiums that were taken into account to those necessary to provide the contractual liabilities.

20. The view that contractual liabilities alone were envisaged is strengthened by the terms of regulation 64(2) and (3). Regulation 64(2) dealt with prospective liabilities "as determined by the policy conditions" for each existing contract. It is relatively easy to identify examples that provide content for the provision. Equitable's personal pension contracts from July 1988 until 1996 provided expressly for an investment roll-up rate of return (GIR) of 3½% per annum on premiums net of expenses. That, on any view, was a prospective liability of the Society determined by the policy conditions. All future bonuses, on the other hand, were, in terms of the policy conditions, dependent on allotment by the Board 'by way of addition to or bonus thereon', directly in terms of the earliest retirement annuity contracts, or by way of the definition of 'related bonuses' in later forms. While there are arguments on the formulations used by the Society in and after 1989, it would be straining the language of the Society's publications and notices as a whole to say that terminal bonus was a liability 'as determined by the policy conditions'. The terms of the contract documents, which I have discussed in chapter 2, drew a clear distinction between benefits that were liabilities in terms of the policy conditions and benefits that were not.

Third Life Directive

21. The 1994 regulations implemented the 3rd life directive[13]. On 29 August 1990 the single market directorate general of the European Commission (DG XV) issued a working document in completion of the internal market in life assurance. The document proposed a basis for a third life insurance directive that would introduce a comparable 'single licence' or 'passport' regime to the regime agreed for banks in 1989. As with other market-opening measures, a degree of harmonisation was also proposed. Among other things, the Commission proposed "to harmonise the general principles on which technical reserves are calculated" rather than seek "to apply detailed rules".

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[12] A Solvency Standard for Life Assurance Business, R Skerman, the Journal, 1966, to which I shall refer later in discussing policyholders' reasonable expectations. See chapter 13, paragraphs 34 to 37. Also paragraph 36 below.

[13] Council Directive 92/96/EEC.

22. The basis for harmonisation was to be the five actuarial principles for calculation of technical reserves already proposed by the *'Groupe Consultatif'*[14]. These principles included the following:

> "(a) ... the technical provisions should be calculated on a suitably prudent basis, and not on a 'best estimate' basis.
>
> (b) The calculation of technical reserves should take into account all the benefits guaranteed to be available under the conditions of the policy; this would include, for example, the provision of guaranteed surrender values; the detailed principles should require the technical reserves to be at least as great as any surrender value guaranteed.
>
> (c) The calculation of technical reserves should take into account the reasonable expectations of policyholders in respect of future bonuses and terminal bonuses; it should be made clear that this does not mean that the insurance company should be able to pay on its present scales indefinitely, but that the method of distribution of bonus will continue to take account of the 'surplus' or 'profit' on interest, mortality, expenses etc in the same sort of way as the present method, whatever that method may be."

Principle (d) concerned non-discrimination between domestic and "non-domestic" policyholders, while principle (e) said that the method of calculation of technical reserves for liabilities should be compatible with the method of valuation of the corresponding assets.

23. The third principle, (c), was explicit in its reference to policyholders' reasonable expectations and the need to provide for future bonuses by reference to current practice. I understand that the drafting of this principle may have been heavily influenced by the UK representative on the *Groupe Consultatif*.

24. A draft directive was subsequently issued by the Commission on 29 October 1990. Article 15, in which the five principles had become six, proposed to replace article 17 of the first life directive. The proposed new article 17 would read:

> "The home Member State shall require every insurance undertaking to establish sufficient technical provisions, including mathematical provisions in respect of its entire business.
>
> The amount of such technical provisions shall be determined according to the following principles:
>
> 1.(i) The amount of such technical provisions shall be calculated by a sufficiently prudent actuarial valuation of all future liabilities for all existing policies, including:
>
> - guaranteed benefits, including guaranteed surrender values ...
> - bonuses which have already been guaranteed, whether described as vested, declared or allotted;
> - options available to the policyholder under the terms of the contract;
> - future expenses including commissions;
>
> taking credit for the premiums which are due to be paid under the terms of each policy. ..."

Principle 2 provided that the rate of interest to be used in calculating the technical provisions should be chosen prudently, taking account the currency in which the policy[ies] denominated, and having regard to the yield on the corresponding existing assets and to the yield which it is expected will be obtained on sums to be invested in the future."

[14] *Le Groupe Consultatif des Associations d'Actuaires des Pays des Communautés Européennes.*

Principle 3 required the prudent selection of the basis for calculating provisions for expenses. Principle 4 dealt with future bonuses for with-profits policies thus:

> "In the case of participating policies, the valuation method shall take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonus. Where no explicit allowance is made for future bonuses a technical rate of interest shall be used that is lower than the rate chosen according to principle 2 by an appropriate amount."

Principle 5 provided for prudent allowance for future profits, while principle 6 required that:

> "The method of calculation of technical provisions from year to year shall be such as to recognise profit in an appropriate way over the duration of each policy, and shall not be subject to discontinuities arising from arbitrary changes to the valuation basis.".

Some of the drafting changed in a second draft issued on 18 January 1991 (the principles were again re-designated, this time from A to F), but these provisions were essentially unchanged.

25. The directive was formally adopted by the Commission as a proposal on 20 February. An accompanying Commission explanatory memorandum noted that:

> "As regards the definition and calculation of technical provisions, this proposal for a Directive establishes co-ordination on the basis of actuarial principles that have to be respected by every insurance undertaking."

It went on to record the conclusion of the *Groupe Consultatif* that harmonization on the basis of the principles would be "sufficient to ensure effective protection of lives assured in the context of a single licence system". The new article 17 therefore laid down "sound and prudent principles" on the basis of the suggestions from the *Groupe Consultatif*. However, it was noted that, even after the proposed harmonisation:

> "... there will remain a large number of actuarial methods and bases capable of satisfying these principles. Paragraph 2 of this article therefore provides that the methods and bases used by each undertaking must be published. Even if this information is too technical to be readily understood by most policyholders, the mere fact that it is freely available is an added inducement to the undertaking to exercise prudence."

The idea of 'freedom with disclosure', for long a principle applied in domestic regulation, also underpinned the harmonisation proposed by the Commission.

26. An internal Treasury memo of 18 June 1991 noted that DTI believed that other Member States (unspecified) were likely to propose a more cautious approach on articles 15 (the new article 17 on technical reserves) and 16 (premiums for new business) that could lead to "over-cautious reserving and higher premiums".

27. The first substantive discussion of these provisions took place at a Council working group meeting in Brussels on 9 and 10 January 1992. There was, according to the DTI note of the meeting, "a great deal of confusion" about the purpose of the principle concerning future bonuses (now principle D). The UK delegation explained to the working group that the provision reflected the system in the UK and Ireland, where with-profits policies were valued using a lower interest rate than other policies. It was suggested that, so long as this was adequately dealt with under the first principle, perhaps principle D was unnecessary.

28. During the same discussion the German delegation proposed that supervisory authorities should be required to set a maximum interest rate for valuation, a proposal that would dominate discussions on this part of the directive. This was picked up in alternative proposals for changes to the text from the German and

French delegations tabled for the next working group meeting on 20 and 21 January. The German proposal would have required the home State authorities to set a maximum rate after consultation with the relevant monetary authority and sought to give the EU Insurance Committee a role in the setting of these maxima. The French proposal went further in setting criteria for the maximum rate. The UK delegation "led the resistance" to both. DTI advice to the Minister for Consumer Affairs reveals a concern that a single rate "would simply not fit" the range of contracts sold in the UK. A UK paper was subsequently tabled on 5 February ahead of another 2-day working group meeting and bilateral discussions were held with the Germans and French.

29. On 21 February the Council circulated a revised draft directive. Principle A(i) was revised to read:

> "A (i) The amount of the <u>technical life assurance</u> provisions shall be calculated by a sufficiently prudent <u>prospective</u> valuation of all future liabilities <u>in accordance with the conditions laid down for each existing policy</u>, including ..." [15]

This wording had been proposed by the Presidency at the working group on 9 January, though it is unclear from the papers the inquiry has seen at whose request the words "in accordance with the conditions laid down for each existing policy" were included. A Presidency proposal was also included on the maximum interest rate, which would simply have required home member States to set a maximum. And a number of scrutiny reserves were noted on principle D.

30. The UK delegation questioned the new wording for principle A(i) at the next working group meeting on 5 and 6 March. It was agreed that the word 'actuarial' would be reinserted before 'valuation', but no explanation was forthcoming for the Presidency's additional words. The UK and Italy withdrew their reservations on principle D, but four scrutiny reserves were maintained[16]. At the working group meeting on 16-17 March the focus switched back to the maximum interest rate debate on which the Presidency had proposed a second compromise, less attractive to the UK delegation than the first. There were no significant changes to the relevant provisions in the draft directive circulated by the Council secretariat on 20 March, and the debate dominated again at the meeting on 30-31 March, with the UK still supported by the Netherlands, Ireland and the Commission. Again there were no significant changes to the text of 3 April.

31. At an 'ad hoc' meeting of financial attachés on 9 April[17], a third Presidency text (this time devised by France and the UK) was proposed that offered the prospect of progress on this issue. At a further meeting of the attachés on 27 April it was noted that nine of twelve Member States could accept, and it was decided to refer the whole draft compromise text and remaining issues to a meeting of deputy permanent representatives on 5 May. The UK note of the meeting records that in the course of the discussion on 27 April the Netherlands proposed that if the Presidency text on principle B (maximum interest rates) was acceptable, principle D (the text on future bonuses) was no longer necessary. The Commission disagreed and proposed instead that only the second sentence of principle D (the part of the text requiring a lower interest rate to be applied where no explicit allowance for future bonuses was made) should be deleted. It was noted in the official Council note that some delegations still had doubts over this provision, and that the Commission had proposed the deletion of the second sentence as a compromise.

32. At the meeting of deputy permanent representatives on 5 May a compromise was agreed on maximum interest rates, and according to the official UK telegram it was agreed not only that the second sentence of principle D should be dropped, but

[15] Changes highlighted in original.
[16] France, Belgium, the Netherlands and Spain.
[17] In this context '*ad hoc*' signifies that policy experts from the relevant ministries could attend as well as the attachés from permanent representations.

also that the provision should become "optional in character". The official Council secretariat note of the meeting that was circulated with a revised text on 8 May in preparation for a discussion at the Internal Market Council on 14 May made no mention of this conclusion, which appears to have been regarded as a minor consequential amendment. The inquiry has seen no papers that explain at whose suggestion the provision was made optional[18]. The text that was circulated on 8 May duly omitted the second sentence of principle D and made the requirement to take account of future bonuses permissive rather than mandatory by replacing "shall" with "may". Thus principle D now read:

> "In the case of participating policies, the method of calculation for technical provisions may take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonus."

Political agreement was reached at the Internal Market Council.

33. The text appears unaltered following a subsequent meeting of jurist/linguists, but the wording of principle A(i) seems unaccountably strengthened in the common position text circulated by the Council secretariat on 15 June. It now read:

> "A (i) The amount of the technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing policy, including ..." [19]

Principle D on future bonuses remained unchanged from the optional text put to the Internal Market Council.

Implementation of the Third Life Directive

34. The 1994 regulations brought forward the 1981 definitions of 'long term liabilities', provision for the amount of liabilities to be determined in accordance with generally accepted accounting principles, and the stipulation that all contingent and prospective should be taken into account. However, as indicated above, regulation 64 limited the determination of the amount of long-term liabilities to prospective liabilities as determined by the policy conditions. The UK did not take advantage of principle D to introduce a requirement for prudent reserving for future terminal bonus payments.

35. In summary, the position under the 1994 regulations was that the factors to be taken into account in calculating the minimum statutory solvency basis were:

i. Sufficient provision had to be made for liabilities to ensure that, assuming the office's actual experience was as favourable as the valuation assumptions, no further capital was required to support policies.

ii. The maximum valuation rates of interest had to have regard to the yields on the existing assets attributable to the long-term business and, to an appropriate extent, the expected future yield. In particular:

   a. Assets must be valued in terms of the 1994 Regulations;

   b. Certain asset yields might be limited in accordance with the 1994 Regulations;

   c. Adjustments were to be made for the risk that income and capital repayments might not be received as expected; and

   d. The rate of interest could not exceed 97.5% of the actual weighted average adjusted yield on the assets.

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[18] Although the inquiry has seen professional actuarial papers that suggest that this was seen as a significant concession gained by the UK, see chapter 13, paragraph 97.
[19] Highlighting added.

iii. Prudent mortality tables were to be used taking into account the company's own past experience and published tables.

iv. Provision was to be made for the excess of future expenses over the future policy margins on existing contracts taking into account past experience and expected future inflation.

v. Options and guarantees were to be allowed for.

vi. No allowance was to be made for any potential reduction in liabilities due to lapses.

vii. Negative policy values were excluded, and

viii. Account had to be taken of the nature and terms of the assets backing the long-term fund and of the effects of possible future changes in the values of these assets and their adequacy to meet liabilities (i.e. the resilience test – sensitivity analysis).

36. These requirements effectively imposed a minimum reserve on a net premium basis. For with-profits business, there was a further requirement that if a gross premium basis were used, the value of liabilities must at least be as great as those that would be produced using the net premium method. However, as a matter of requirement, the whole computation was related to contractual liabilities. The selection of the net premium basis of valuing liabilities was originally supported on the ground that it allowed for the managed release of future surplus and met policyholders' reasonable expectations of future bonuses. The language echoed Ronald Skerman's original principles of valuation, and in particular the first principle that supported the net premium basis of valuation[20].

37. In the result, the 1994 regulations did not require the recognition of liabilities based on the quantification of accrued terminal bonus, either absolutely as a reflection of the reality of management of the insurance enterprise, or as a reflection of policyholders' reasonable expectations. The regulations stated that the liability should be determined in accordance with generally accepted accounting practice and methods appropriate for insurance companies, provided that the amount provided for in the regulatory return should not be less than the statutory minimum basis. As compared with the basis of the statutory accounts, it would appear that the regulations required that the minimum basis assumed a more conservative value, while the statutory accounts were prepared on the assumption that the entity was a going concern, and that that was the fundamental difference between the two bases.

38. I shall discuss later the reasonable expectations generated by the Society's references to allotted and accrued terminal bonuses in notices, correspondence and publications. For present purposes, I consider that it is clear that nothing said by the Society established policyholders' reasonable expectations of future and in particular terminal bonuses as prospective liabilities as 'defined by policy conditions'. The specification of this class of liabilities in regulation 64(2) of the 1994 regulations effectively excluded cases where there was not a defined contractual basis. The specific examples selected for illustration of long-term liabilities in regulation 64(3) point even more strongly in that direction[21]. One might be forgiven for wondering why it was necessary to identify 'guaranteed benefits' as liabilities at

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[20] Skerman, 1966. See paragraph 19 above and chapter 13, paragraph 36.

[21] "(3) Without prejudice to the generality of paragraph (1) above, the amount of the long term liabilities was to be determined in compliance with each of regulations 65 to 75 and was to take into account, inter alia, the following factors:

a. all guaranteed benefits, including guaranteed surrender values;

b. vested, declared or allotted bonuses to which policy holders were already either collectively or individually contractually entitled;

c. all options available to the policy holder under the terms of the contract; and

d. expenses, including commissions."

all: there was no other way of understanding the term. The same applies to the references to vested, declared and allotted benefits 'to which policyholders are already ... contractually entitled'. However, the specification of these benefits at least suggests that the regulation did not have in contemplation a possible benefit that might never mature, or if it did mature might be of value considerably less or more than currently anticipated because of external market conditions.

Accounting standards and guidance

39. The discussion so far has left out of account sub-paragraphs (1) and (2) of paragraphs 52 and 60 of the 1981 and 1994 regulations respectively which, as noted above, provided that the amount of liabilities in respect of long term business was to be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies, and that all contingent and prospective liabilities were to be taken into account. I shall return to the implications of these provisions after discussing the Companies Act accounting requirements.

40. Until the Companies Act 1948 came into force, insurers were permitted to file regulatory returns in lieu of financial statements. The 1948 Act prescribed few rules governing the form and content of financial statements, but required that such statements should give a 'true and fair view' of the entity's state of affairs and profit or loss for the relevant accounting period. The Cohen Committee on company law considered that it was in the public interest that certain financial companies, including insurance companies, should be permitted to maintain undisclosed reserves. Mechanically, this translated into authority to include reserves in the liability provisions shown on the face of the balance sheet. The liabilities were inflated, and the general reserves of the company reduced accordingly. The company's resources available to distribute bonuses, and in the case of proprietary companies dividends, were understated. Exposure to the risk of demands for increased distributions was reduced.

41. This structure was repeated in the Companies Act 1985 which was in force for most of the material period. General companies were required to prepare financial statements in terms of schedule 4 to the Act. Insurers were permitted to prepare annual financial statements in accordance with schedule 9. Schedule 9 contained modifications of and exemptions from the provisions applying to general companies that relieved insurance companies from the duty to disclose amounts of or movements in provisions or reserves.

42. The 1985 Act required the directors of all companies to prepare accounts which showed a 'true and fair view' of the company's state of affairs at the end of the financial year and of its results for the financial year then ended[22]. The true and fair requirement was central to the regulation and control of financial reporting. All

[22] In Accounting Provisions of the Companies Act 1985, Johnson & Patient, paragraph 3.09/10, p24. The legal consultant editor was Mary Arden, now Lady Justice Arden. The 'true and fair' requirement was reiterated as follows:

> "All financial statements drawn up under the Act (CA) must present a true and fair view [Sec 228(2)]. This requirement is fundamental. It overrides the requirements of Schedule 4 (which contains detailed rules on the format and content of company financial statements) and all other requirements of the CA as to matters to be included in a company's financial statements [Sec 228(3)].
>
> The Act illustrates the circumstances in which the true and fair override will come into play. Section 228(4) of the Act states that, where information additional to that which the Act requires is needed for the financial statements to give a true and fair view, those financial statements must include that additional information. Section 228(5) then goes on to provide that a company must depart from that requirement if its circumstances are such that, if it complied with a particular requirement of the Act, and even if it gave additional information, this would not result in a true and fair view."

financial statements had to be prepared on a basis that sought to achieve this requirement. In the case of general companies, making appropriate provision for a company's liabilities has at all times had to be considered in the context of this requirement. A company's statutory accounts may not be deemed to be true and fair as a whole if the company's liabilities are materially under- or over-stated.

43. The provisions relating to 'special category companies', such as insurance companies, were intended to adapt the general rules to the requirements of their businesses. The Companies Act 1985 permitted special category companies to elect between preparing accounts in terms of the general requirements of the Act set out in schedule 4 or applying the special provisions of sections 258 to 262 of, and schedule 9 to the Act as amended from time to time. The effect of the exemptions provided by schedule 9 was defined negatively. Where the schedule 9 exemptions were adopted, the financial statements would not be deemed not to give a true and fair view as required by the Act, by reason only that they did not give the information required by the provisions from which they were exempt.

44. The basic requirements were developed over time in primary and secondary legislation, and in published statements of recognised professional practice. Companies were required to have regard to rules contained in statements of standard accounting practice ('SSAPs', the then prevailing standards) and in other authoritative accounting statements such as industry statements of recommended practice ('SORPs') and emerging practices such as exposure drafts ('EDs'). The accounting records maintained by companies had to be sufficient to enable the directors to prepare financial statements that complied with those prescriptive rules and where appropriate took account of issued guidance.

45. Financial statements prepared by special category companies in accordance with schedule 9 had to contain a statement that they had been prepared in compliance with chapter II of part VII of schedule 9 to the Act. The accepted view was that special category companies were bound by the overriding requirement that the balance sheet and the profit and loss account must give a true and fair view of the company's state of affairs and the profit or loss for the financial period. The requirement that the balance sheet and profit and loss account must comply with the provisions of schedule 9 was without prejudice to any other requirements of the Act. Some special category companies were exempt from many of the requirements even of schedule 9. Where these exemptions were adopted the financial statements were not deemed not to give a true and fair view as required by the Act by reason only that they did not give the information required by the provisions of schedule 9 from which they were exempt.

46. Subject to any directions by the Secretary of State, an insurance company that was a special category company might take advantage of specified exemptions. In its balance sheet, an insurance company did not require, in respect of liabilities and reserves, to classify reserves, provisions, liabilities or assets under suitable headings, or show the aggregate amounts of reserves and provisions and the movements on such reserves and provisions during the year, or give the details of any other contingent liabilities. If an insurance company took advantage of the exemption from stating its reserves and provisions separately or describing them as such, its financial statements had to identify any heading in the balance sheet that contained a reserve or provision. In respect of the profit and loss account, exemptions relevant for present purposes provide that an insurance company need not give details of the amount set aside to, or proposed to be set aside to, or withdrawn from, reserves or provisions. If an insurance company took advantage of the exemption from stating its reserves and provisions separately or describing them as such, its financial statements had to explain how such reserves and provisions had been treated in the profit and loss account.

47. In general terms, the objective of a company's statutory accounts is well understood:

'The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.

That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user. Present and potential investors need information about the reporting entity's financial performance and financial position that is useful to them in evaluating the entity's ability to generate cash and in assessing the entity's financial adaptability."

Though formulated with shareholders in mind, the comment is equally pertinent as a statement of the objective appropriate to members of a mutual life insurer.

48. The accepted view of the 'true and fair' requirement following its introduction in the 1948 Act had been moulded by legal advice obtained on the instructions of the Accounting Standards Committee (ASC). It was treated as a dynamic criterion, reflecting circumstances, but broadly requiring that financial statements should provide information of a quality and quantity sufficient to satisfy users' reasonable expectations. Those expectations were reflected in and moulded by accounting practice, and in particular had regard to accounting standards of general application and professional guidance. It was expected that the courts would have regard to such statements as a measure of whether accounts gave a true and fair view of the matters stipulated in the Act.

Accounting Standards Board

49. Practical implementation of the statutory provisions required the development of accounting and other standards for the preparation of general companies', and special companies' accounts. The responsibility for developing standards has changed over time. Until August 1990 the responsibly for developing accounting standards was discharged by the ASC. Since August 1990 that responsibly has been discharged by the Accounting Standards Board (ASB).

50. The Foreword to Accounting Standards approved by the ASB described in particular the circumstances in which accounts are expected to comply with accounting standards. Notwithstanding its date, it described the position that obtained over the earlier period of the ASC's jurisdiction. Paragraph 16 states:

"Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in the financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

An extensive process of investigation and consultation precedes the issue of a standard and the major accountancy bodies expect their members to observe the resulting statements as a measure of professional duty. Apparent failure by members to observe standards or ensure adequate disclosure of departures from them may result in disciplinary proceedings."

51. The foreword described the role of accounting standards as identifying proper accounting practice for the benefit of preparers and auditors of accounts. It referred to the provisions of the Companies Act 1989 that gave statutory recognition to the accounting standards and by implication to their beneficial role in financial reporting for general and special category companies.

52. SSAPs issued by the ASC and, subsequently, financial reporting standards (FRSs) issued by the ASB were applicable to all financial statements intended to give a true and fair view. Such standards could not and did not override statutory exemptions available to, and utilised by, life offices. Furthermore, certain standards modified the application of the general standards in their application to insurers or exempted insurers from certain of the requirements.

53. These domestic arrangements had to be related to the wider international context of developing accounting standards. The accounting professions' position was that:

> "FRSs are formulated with due regard to the international developments. The Board (ASB) supports the International Accounting Standards Committee in its aim to harmonise international financial reporting. As part of this support an FRS contains a section explaining how it relates to the International Accounting Standards (IAS) dealing with the same topic. In most cases, compliance with an FRS automatically ensures compliance with the relevant IAS. Where the requirements of an accounting standard and an IAS differ, the accounting standard should be followed by entities reporting within the area of application of the Board's accounting standards."

54. The centrality of authoritative published standards in securing compliance with the statutory criterion of 'true and fair' financial reporting could hardly have been expressed more forcibly than it has been by the representative bodies' statements. They were intended to form a central role in the preparation of financial statements. They were intended to guide auditors and others in the examination of financial statements and expressing professional views on them. It is against this background that one of necessity has to examine the state of play in relation to insurance accounting.

55. The position can be stated starkly. There are no UK accounting standards that specifically relate to insurance companies. So far as accounting standards are concerned, the insurance industry largely escaped accounting regulation. Some general standards specifically exempted insurers from certain of their requirements[23].

SORPs

56. The Association of British Insurers (ABI)[24] has published four SORPs on accounting for insurance business. The first 'Statement of Recommended Practice on Accounting for Insurance Business' was issued in December 1986. The second SORP was issued in May 1990, and the third in December 1998. The fourth SORP was recently published in November 2003. The objective in each case was to set out current best accounting practice incorporating the insurance industry's many unique features. This guidance was issued in order to implement general accounting standards more effectively.

57. Prior to the first issue, annual financial statements were prepared more on a compliance basis than with the object of presenting a true and fair view. The exemptions provided in schedule 9, if utilised, overrode the requirements of any SSAP. Insurance businesses were required to adhere to the accounting concepts of going concern, accruals, consistency and prudence[25]. However prudence was thought to override the accruals basis in certain circumstances. For example, the prudence concept accommodated the use of precautionary 'margins' in the estimation of liabilities to create hidden reserves that would have been precluded by the accruals basis applying to general companies.

58. The long-term business provision in life companies accounts had to be calculated by an actuary. The 1982 Act contained an explicit requirement that the long-term business provision be computed by the appointed actuary for regulatory purposes. A parallel requirement was only made explicit for statutory accounts purposes in the 1985 Act as amended on the adoption of the requirements of the third life directive. The actuary was required by the amended provisions[26] to

[23] SSAP 19; FRS 1 and FRS 3.

[24] Formerly known as the British Insurance Association (BIA). It was as the BIA that they published the first SORP.

[25] SSAP 2.

[26] Paragraph 46 of schedule 9A to the Companies Act 1985.

compute the long-term business provision on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down by the third life directive. However, generally, the actuary was obliged to comply with both legislation and guidance issued by the actuarial profession when performing the liabilities valuation. From 1986, the prevailing view was that departure from accounting concepts did not require to be disclosed because of the actuary's obligations in this respect. In relation to the valuation of the long-term business liability, this qualified the general rule that (with certain exceptions) any departure from fundamental accounting concepts required to be disclosed.

59. The preparation and publication of the first SORP did not follow accepted consultative procedures. Description of a statement as a 'SORP' implied that the consultation procedures specified by the ASC had been followed and that the ASC had approved the statement. In the case of a SORP published after due procedure, the practice of the ASC was to publish a statement that the Committee did not consider that the statement was in conflict with accounting standards. The first SORP was not endorsed, and did not achieve general recognition: it was guidance for the Association's own members only. In terms of content, the first SORP was directed to improving the quality of information disclosed in accounts rather than the accounting principles to be used. Consequently it did not address fundamental accounting issues (including accounting for investments), which arose from the statutory exemptions available to insurers. In the case of life insurers, the SORP endorsed the use of figures in the regulatory returns for the purposes of the Accounts.

60. The second issue of the SORP in May 1990 had the approval of the ASC and set out the recommendations intended to represent current best practice in respect of the form and content of accounts. Although SORPs were not mandatory, entities falling within their scope were encouraged to follow them and to state in their Accounts that they had done so. Profit as reported by many insurers did not reflect nor have any bearing on the successes and performance of a business in the current year. Consequently a more realistic profit performance basis was sought.

61. The second SORP addressed the accounting treatment of investments. In addition it dealt with the issue of the valuation of long-term liabilities, based on the statutory basis of valuation of long-term liabilities modified to reflect quantified actuarial surpluses as reserves, rather than generally accepted accounting practice. The method was known as the 'modified statutory basis', or the 'modified statutory solvency basis' (MSSB). This approach could in some cases result in financial statements being prepared on a true and fair basis, but cautious actuarial practice tended to result in conservative provisions for liabilities and consequent understatement of reserves.

62. The ABI recognised the accounting issue that arose, which was resulting, amongst other things, in published financial statements failing to provide investment analysts and other commentators with the information they needed. Consequently the ABI proposed that life office accounts should have profit reported on the basis of change in embedded value during the year. The embedded value method placed a value on the in-force portfolio of policies and accordingly reflected the present value of the whole of the profits expected over the life of the policy at inception. Thus profit would be recognised as the annual movement in this value.

63. The embedded value method was however not generally agreed to be compatible with accepted accounting principles and accordingly it could not comply with the requirements of the insurance accounts directive[27]. Even if, on a technical basis, the ABI's proposed method had complied with the law, it would have failed to meet the need for an accounting solution in which the constituent elements of embedded value were appropriately accounted for. Additionally, the ABI's proposal applied to group accounts which meant that subsidiaries could prepare their

[27] Council Directive 91/674/EEC.

accounts on different bases which would result in fundamentally different true and fair views being brought together at a group level. It was thought by some commentators that the appropriate accounting treatment required to achieve a true and fair view would bring a "realistic provision" into the financial statements which would have the effect of spreading profit over the life of the policy.

64. The development of the third SORP commenced in 1993, but progress was slow and it was eventually released in 1998. The key objective of the SORP was to secure an appropriate treatment and disclosure of investment returns. It set out its principal objectives as being:

> "to set out recommended accounting practice for the UK insurance business within the framework of the Companies Act 1985 in order to narrow the range of accounting practices and thereby enhance the usefulness of published accounting information; and
>
> to provide guidance on certain [provisions] of the CA85 relating to the financial statements of insurance undertakings where the wording of these provisions requires clarification, or is insufficient in itself to ensure a uniform interpretation of the requirements, or would result in an inappropriate diversity of accounting practice."

Accounts were now intended to reflect a smoothed return through the profit and loss account with the appropriate transfer to or from reserves so as to reflect reconciliation to actual investment returns achieved during the year. This disclosure was intended to lead to greater transparency and to relate distributed smoothed returns to actual earned returns. The third issue SORP of December 1998 was approved by the ASB. The ABI was approved for the purposes of issuing recognised SORPs containing recommendations on accounting for insurance business including accounting for investments.

65. In November 2003, the ABI released its fourth SORP designed to give effect to the differing influences of general accounting practice, the requirements of schedule 9A of the Companies Act 85 and detailed regulatory requirements. The SORP set out areas in which insurance accounting did not align with 'general purpose' accounting practice. These areas included:

- the deferral of acquisition costs as assets;
- the inclusion of both members' equity interests and liabilities in the fund for future appropriations;
- the measurement of provisions for liabilities to policyholders on a regulatory, solvency basis rather than at the best estimate of the expenditure required to settle them; and
- the measurement of such liabilities using discount rates based on asset yields, which was inconsistent with certain prescribed accounting standards (FRS 12, 17 and 19).

66. With the exception of the above, the ABI have indicated that the SORP does not appear to conflict with accounting practice or standards. The key developments of relevance to the inquiry contained in this SORP are: the definition of financial reinsurance as opposed to reinsurance, and the requirement that long-term business should be valued in accordance with the gross premium method as defined which explicitly excludes any account of terminal bonuses.

67. Professional guidance has been slow in development and inconsistent in results. Existing guidance gives the impression of a struggle to come to terms with statutory and other requirements while the industry has developed a diversity of practices and while the scope of its business has altered beyond the assumptions that obtained at the start of the process. For present purposes, the material issues arise in connection with the treatment of liabilities in this context.

The International Context

68. The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993[28] implemented the EU insurance accounts directive by introducing a new schedule 9A to the 1985 Act, which substituted for the existing accounting rules. With effect from financial years commencing on or after 23 December 1994, insurance companies have been required to comply with the new schedule 9A to the 1985 Act in the preparation of their financial statements. The new schedule applied to accounts prepared from December 1995 onwards (although Equitable adopted it for its 1994 accounts). It provided a mandatory format for the accounts of insurance companies and limited the flexibility previously available to insurers by removing the disclosure exemptions. This resulted in the financial statements of insurers being required specifically to show a true and fair view. The new format required separate disclosure of the long-term business provision, liabilities and amounts constituting undistributed surplus, either in reserves or in a 'fund for future appropriations' (FFA).

69. Schedule 9A required an insurance company's balance sheet to include in its technical provisions a long-term business provision (LTBP) which "shall comprise the actuarially estimated value of the company's liabilities...including bonuses already declared" (note 21, paragraph 9). Paragraph 43 of schedule 9A states that "the amount of technical provisions must at all times be sufficient to cover liabilities arising out of insurance contracts as far as can reasonable be foreseen." Paragraph 46 of schedule 9A provides for the LTBP to be computed annually "on the basis of recognised actuarial methods, with due regard to actuarial principles laid down in [the third life directive]".

70. Article 18 of the third life directive provided that "the amount of technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking into account all future liabilities as determined by the policy conditions for each existing contract, including:

- all guaranteed benefits, including guaranteed surrender values;
- bonuses to which policy-holders are already either collectively or individually entitled, however those bonuses are described – vested, declared or allotted;
- all options available to the policy-holder under the terms of the contract".

The actuary whose duty it was calculate the LTBP (in accordance with section 46(3) of schedule 9A to the Companies Act 1985) was designated the 'Reporting Actuary' under GN7.[29]

International Accounting Standards

71. Internationally as well as domestically, the development of an acceptable framework of accounting standards for insurance business, both general and long-term, has proved to be an intractable problem that has so far eluded solution. In the international context, a degree of urgency was introduced in March 2002 when the European Parliament approved a Financial Services Action Plan that included a requirement that all EU listed companies must adopt International Accounting Standards Board (IASB) standards for consolidated financial statements from 2005, subject to optional deferment until 2007. But by then there had been a recognised need for standards over many years. The history of attempts by the IASB (and its predecessor, the IASC) to achieve agreement on a statement of principles has been

[28] SI 1993/3264.

[29] Guidance Note 7, 'The Role of Actuaries in Relation to Financial Statements of Insurers and Insurance Groups writing Long Term Business and their Relationship with Auditors', issued by the Institute and Faculty of Actuaries.

widely discussed[30]. It is a matter of concern that IASC and IASB attempts at promulgating appropriate standards appear to have been frustrated thus far.

72. The IASB has been engaged on an insurance contracts project since publication of an issues paper in December 1999. Work began on a draft statement of principles (DSOP) in December 2000. The first insurance standard, which is primarily a disclosure standard, is not expected until 2005. Insurance 2, which is intended to deal with accounting methods, is not expected until 2006. While superseded as a statement of the likely approach for the future, the DSOP provided an indication of professional thinking, however qualified, at the time of its issue. It envisaged the recognition of insurance liabilities exclusively in terms of contractual obligations. If the DSOP proposals were resurrected, the development of accepted international accounting principles would not require the recognition in accounting statements of non-contractual interests of policyholders such as might be generated by policyholders' reasonable expectations.

73. Some general accounting guidance was provided in the publication 'Elements of Financial Statements', referred to in the DSOP, a guidance document outlining the conceptual framework for accounts issued by the IASC in 1990. In terms of that guidance, a 'present obligation' was a pre-condition of recognition of a liability.[31]

74. On 31 July 2003 the IASB issued a consultation paper setting out the Board's exposure draft of phase 1 of its project on insurance accounting in part-implementation of its programme of proposals to meet the requirements of the action plan. The phase 1 proposals are an interim step towards the radical reshaping of accounting for insurance business. The announcement attracted considerable opposition to the proposals. An ABI spokesperson alleged that the proposals had not been thought through. The European Commission was said to be pressing the Board to hold urgent talks with the industry. The Geneva Association, representing leading insurers, expressed concern about the proposals. The reactions reflected, or appeared to reflect, fundamental underlying differences of opinion as to the role of insurance accounting in instructing a uniform approach to the preparation and publication of financial statements.

75. It would be inappropriate in a report on Equitable to attempt to provide a comprehensive analysis of the development of accounting standards generally, or even of those that have touched on the accounting treatment of long-term insurance liabilities. But the general picture is clear: domestic and international accounting bodies tasked with the development of appropriate standards have failed to produce binding solutions to many of the problems that have been identified by them and other institutions. To date, and no doubt because of the complex nature of insurance liabilities and the fact that such liabilities are required to be determined by the appointed or reporting actuary, no specific accounting standards have been issued by the appropriate accounting standards setting bodies, domestically or internationally. Rather the insurance regulations have governed these requirements in addition to actuarial guidance issued by that profession to its members.

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[30] See, for example, the report to the Accountancy Task Force of the Geneva Association set out on the Geneva Association web site at www.genevaassociation.org and summarised in a paper by Professor Dickinson in the Journal of Insurance Research and Practice, July 2003, page 50.

[31] Elements of Financial Statements, IASC 1990. It defined a liability as "a present obligation of the enterprise arising from past events, the settlement of which is expected to resulted in an outflow from the enterprise of resources embodying economic benefit." On recognition it said that a liability "should only be recognised in the balance sheet if the "outflow" is probable and the "amount" is reliably measurable". As recognised in the DSOP, this definition identified probability of payment as a factor in recognising liabilities. However, in order for an item to be regarded as a liability, it had first to meet the accounting definition of a liability as a 'present obligation' arising from past events. An item might appear to meet the definition of a liability but it might either not be probable that an outflow will be generated by it, or any such outflow is reliably measurable in which case no value would be recognised in the balance sheet. However these issues arose only once a present obligation had been identified.

Treatment of the Society's Accrued Terminal Bonus

76. After the introduction of the Society's new bonus system in 1989, Equitable policyholders received annually an explicit allotment of aggregate uplift in the policy values of their contracts, including terminal bonus in an un-guaranteed form. Declared bonus once allotted was provided for in the Society's long-term business provision, but no provision was made in the Society's liabilities for terminal bonus allotments. Nor was any explicit reserve held in the investment reserve and later the FFA to match the accumulated balance of these allocations. The Society's rationale for this approach was that such allocations were not guaranteed and that the value 'accrued' to a policy could be changed by the Society, and in particular could be reduced to zero, at any time. The main influencing factor, as quoted by the Society in its bonus notices to policyholders, that would justify the Society changing this terminal bonus value on a contractual policy termination, would be market conditions.

77. It is clear, in my view, that the Society followed a sustained and systematic pattern of over-allocation between 1987 and 2000 that resulted in contractual terminations receiving policy payouts in excess of the Society's underlying assets attributable to maturing business throughout this period. For non-contractual or early terminations a market value adjustment was applied on terminal bonus from time to time and at various rates in order to align policies values more closely with the underlying assets that might have been attributable to the policies as the claims arose, but there was no sustained or systematic policy that secured balance as a result of an exercise of this kind. In applying its policies, in the case of contractual terminations, the Society paid out the full value of 'accrued' terminal bonus despite market conditions. For non-contractual terminations either full value or an adjusted lower value for terminal bonus was paid out at those periods when a financial adjustment was in operation. But the adjustment was not particular to the excess in the specific case, and the rates applied left considerable scope for residual over-payment.

78. Terminal bonus payouts were made out of current year surplus with the remainder of the actuarially determined distributable surplus being made available for declared bonus or carried forward. Consequently the value of a claim would represent a policy's aggregate policy value with the guaranteed portion being met by a reduction in the Society's liabilities and the non-guaranteed (terminal bonus) portion being met by a reduction in current year surplus. This method was adopted in both the accounts and the return.

79. The Society's ability to account for terminal bonus in this manner circumvented recognition in any form in either the statutory accounts or the regulatory return of the balance of the accumulated terminal bonus accrued on in-force business and intimated to policyholders. Whether or not the Society was under any obligation to account for the accrued value of such terminal bonus allotments (which gave rise to an off balance sheet exposure) in either its accounts or returns depends on meaning and effect of the various reporting requirements discussed earlier.

80. Nothing in the provisions examined above casts doubt on the regularity of the Society's practice. As noted above, section 46(3) of schedule 9A of the Companies Act 1985 states in relation to liabilities that:

> "The computation shall be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down in the Council Directive 92/96/EEC."

What those methods and principles were has not been specified: they were left to the profession.

81. There was no relevant accounting standard. The standards that might have been relevant did not include a relevant requirement. Neither SSAP 18 nor its successor FRS 12 required disclosure of accrued terminal bonus. For present purposes it is sufficient to comment on FRS 12. Its objective was to ensure that appropriate recognition criteria and measurement bases were applied, inter alia, to provisions and that sufficient information was disclosed in the notes to financial statements to enable users to understand their nature, timing and amount. The standard defined four fundamental concepts:

i. Liabilities were defined as obligations of an entity to transfer economic benefit as a result of past transactions or events;

ii. Provisions were made for liabilities of uncertain timing or amount;

iii. Legal obligation was defined as an obligation that derived from:

   a. a contract (through its explicit or implicit terms);

   b. legislation; or

   c. other operation of law.

iv. Constructive obligation was defined as an obligation derived from an entity's actions where:

   a. by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity had indicated to the parties that it would accept certain responsibilities; and

   b. as a result, the entity had created a valid expectation on the part of those other parties that it would discharge those responsibilities.

82. The Society was not under a present contractual obligation to pay terminal bonus prior to maturity. On the IASB's approach to constructive obligations, there would be no such obligation at any given reference date to make payment in future. The Society's terminal bonus policy and practice after 1989 had at least some of the characteristics of conduct creating a constructive obligation according to these statements. But there is a feature that negatives a final view to that effect. FRS 12 states:

> "a provision should be recognised when:
>
> - an entity has a present obligation (legal or constructive) as a result of a past event;
> - it is probable that a transfer of economic benefits will be required to settle the obligation; and
> - a realisable estimate can be made of the amount of the obligation.
>
> If these conditions are not met, no provision should be recognised."

83. In respect of 'measurement' the standard states:

> "The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date."

In this regard, the Society had accurate records of value of accrued terminal bonus and policy values (as reflected in their internal office valuation). But that did not represent the value of a present obligation, legal or constructive. One could not conclude that the full value of accrued terminal bonus should have been provided for. Further FRS 12 states:

> "The FRS applies to all financial statements that are intended to give a true and fair view in accounting for provisions, contingent liabilities and contingent assets, except those arising in insurance entities from contracts with policy-holders."

84. It would appear that the basis for this exclusion was that the appointed actuary was required by the 1995 Act to compute the long-term business provision of a life assurance company, on the basis of recognised actuarial methods, with due regard to the actuarial principles laid down by the third life directive. From the examination of the Society's liabilities and from confirmation received by both appointed actuaries in office over this period, no recognition of terminal bonus was made in either the accounts or returns. That reflected the accepted view among actuaries, in GAD and the wider profession.

85. This is an area in which industry and actuarial thought continues to develop. In a technical notice dealing with policyholders' reasonable expectations and terminal bonus, Tillinghast said:

> "Actuaries will, ..., need to apply their view of (policyholders) reasonable expectations in assessing the adequacy of the long term liabilities. This raises many questions as to the level of reserves which should be held. For example, if policyholders expect terminal bonuses, should the actuary reserve for accrued terminal bonuses, or is it sufficient to ensure that the investment reserve is sufficient to cover this liability? How should the actuary act if the investment reserve is not sufficient to cover accrued terminal bonuses at current rates? There will need to be considerable discussion between the appointed actuary and the company's board in this difficult and ill-defined area."

86. In the case of Equitable, there are separate issues whether an alternative provision should have been made on a reasonable accounting estimate. It might be contended that at least the Society's current liabilities, which represent liabilities that will crystallise and be paid out in the ensuing twelve months period from the balance sheet date, should possibly have been provided for. But these are more marginal in impact on the Society's affairs.

87. The more fundamental issue is whether the standards and guidance that had been developed and put in place over the period of interest to the inquiry left a gap in accounting standards and actuarial guidance issued by the respective professions to their members in relation to terminal or final bonus that undermined the statutory requirement that accounts should reflect a 'true and fair' financial position. The failure to provide for the recognition of accrued terminal bonus meant that financial statements failed fully to reflect the financial position of the enterprise. It may be that in general the practice of maintaining substantial free assets provided cover for terminal bonus. The use of the terminal or final bonus mechanism to uplift policy values on termination was common throughout the industry. Equitable's approach in and after 1989, as communicated to its members was unique. But the test of an effective system of standards and guidance is its capacity to control the accounting obligations of those who put the system to the test by operating at the extremes of permissible conduct.

Conclusions

88. In my view, the Society was not required by statute, nor by recognised accounting or actuarial principle or practice, to value and to set up reserves for accrued terminal bonus payments that were likely to be made in the future, notwithstanding the accrual of those future benefits in its office valuation.

89. The Society exploited the freedom from disclosure that this afforded not only by withholding publication of the accrued value of rolled-up future terminal bonus intimated to policyholders, but by progressively reducing guaranteed benefits:

i. By altering the mix of bonus between declared and final elements progressively towards terminal bonus; and

ii. By changing policy conditions to reduce the scope of contractual benefits and increase the scope for allotting terminal bonus.

The Society's published accounts for regulatory and statutory purposes became progressively less relevant as reflections of the actual conduct of business by the Society.

90. This state of affairs was consistent with recognition of contemporary accounting and actuarial practice. That practice had failed to keep up with industry developments and as a result exposed the investing public to the risks associated with inadequate information about the business to which they entrusted their savings.

CHAPTER 11: THE EXTERNAL AUDIT OF A LIFE OFFICE

1. I have explained that it cannot be for an inquiry such as this to enter into the debate on the formulation of appropriate accounting standards. In the same way, it is for the auditing branches of the accounting profession to develop and formulate standards for the performance by auditors of their duties. However, it is appropriate to comment on some of the problems that have arisen from the lack of appropriate standards, especially where, despite compliance with accepted contemporary guidance, financial information describing the experience of Equitable failed fully to disclose the realistic position of the Society, and to ask whether past experience gives particular support to the need for those involved to resolve outstanding issues in the interests of policyholders, and, where relevant, shareholders of life companies. The specific area of interest for present purposes is terminal or final bonus.

2. Without adequate accounting standards, audit must lack an appropriate point of reference in relation to insurance accounts. Policyholders and their advisers, as consumers of accounting information about regulated entities, cannot have a reliable basis on which to reach views on their financial affairs, and in particular on the respective merits of competing providers of products in the insurance market, so long as there remain significant deficiencies in the generally accepted standards that can be assumed to instruct the preparation and, in consequence, the audit of published financial statements.

3. In this chapter, I shall narrate my understanding of the position that obtained generally, but with less emphasis than might have been hoped by some commentators on the final, significant period of Equitable's history. I have not attempted to formulate the scope of Ernst & Young's audit obligations in relation to Equitable's accounts, nor to form or express any view on the firm's own description of those duties. Nor have I sought to form or express any views on Ernst & Young's performance or failure to perform their contractual or general duties of care in the course of audit. To have done so would have been inconsistent with my terms of reference, and it is clear that it could not have been otherwise: the inquiry was not structured so as to allow me to resolve contentious issues of definition of the scope of the firm's duties in contract or duties of care generally in the performance of audit work either in relation to the Society's regulatory or Companies Act financial statements.

4. On 25 July 2003, the Court of Appeal sent for trial the Society's case against Ernst & Young subject to a requirement for amendment that is immaterial for present purposes. The decision identified clearly the difficulty and the complexity of the issues of fact and law that arise in respect of the allegations that have been made by the Society against its former auditors. For the purposes of the striking out application Ernst & Young invited the court to assume that there had been negligence in the performance of their contractual duties. There remained a range of issues, some of which involved considerable novelty, on which there was ample scope for debate. The court has commented on these, and, on the whole, left them for later resolution as the litigation progresses. In addition to the issues debated, negligence will be a live issue at the trial. Any litigant is entitled to have questions that may result in liability for damages focused in adversarial proceedings in which there is an obligation on a proponent to identify and define the allegations to be tested on the evidence, and to have an opportunity to defend his conduct on evidence tendered on his behalf.

5. This inquiry was not set up as an adversarial tribunal. It would have been particularly inappropriate for me to attempt to focus or to resolve issues of negligence or other breach of duty where the views expressed might have related to issues that were properly within the scope of the existing litigation. For the purposes of the inquiry I, not the parties to a dispute, have selected the issues of fact for investigation, having regard to my terms of reference, and I have had the

responsibility of deciding the scope of the investigation of those issues, always with a view to proposing lessons to be learnt for the future rather than resolving disputes over past events.

Auditing Standards and Guidance

6. The present difficulties over accounting standards for insurance entities are inevitably an aspect of the background to any discussion of audit practice. However, despite that and the fact that audit is widely performed by accountants, there are functional distinctions, and the development of practice standards has reflected these. In the United Kingdom and the Republic of Ireland audit standards and guidance have latterly been the responsibility, successively, of the Auditing Practice Committee (APC) and the Auditing Practices Board (APB)[1]. The description of the current position reflects the role of these bodies over time adequately for present purposes. The APB's role is to lead the development of auditing practice with a view to establishing high standards of auditing; meeting the developing needs of users of financial information; and ensuring public confidence in the auditing process by publishing statements of auditing standards (SASs), practice notes (PNs), and bulletins. The APB adopted the standards and guidelines previously prepared by the APC. Old and new SASs have the same status, and the auditing guidelines of the APC have the same status as practice notes. Earlier guidance was published by the Institute of Chartered Accountants in England and Wales (ICAEW) in the form of technical releases.

7. SASs set out either (a) basic principles and essential procedures that auditors are required to comply with in the conduct of any audit of financial statements, except where otherwise stated in the SAS concerned, or (b) additional auditing standards applicable to the conduct of audits of specified types of entity, for example those engaged in specialised industries. The members of the Consultative Committee of Accounting Boards (CCAB) have undertaken to adopt all SASs promulgated by the APB. Failure to comply with the standards set out may lead to disciplinary action by an appropriate regulatory body.

8. Practice notes are designed to assist auditors in applying auditing standards of general application to particular circumstances and industries. Bulletins are designed to provide auditors with timely guidance on new or emerging issues. Practice notes and bulletins are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in SASs, even though they may have been developed without the full process of consultation and exposure used for SASs.

9. The publications of the APB have reflected the APB's objective of establishing a framework of prescriptive, persuasive and other guidance designed to support and assist auditors in carrying out their function, in a context requiring the exercise of professional judgment at all times. Taken together, these publications are intended to prescribe the basic requirements of proper audit practice, and, where they are applicable, it is intended that they should provide all of those who rely on audited financial statements with a high degree of confidence that audit has been carried out within a well-defined and reliable framework. They provide a measure of due performance of professional duty that carries the authority of the profession as a whole.

10. As with any statements of practice, auditing standards and guidance have to be understood in their wider context. The audit function has recently been described by the APB in these terms:

> "The independent audit function is an important aspect of good corporate governance necessary for the maintenance of confidence in the operation of

[1] The APB was established in 1991 by the Consultative Committee of Accounting Bodies.

business, capital markets and the public sector. It provides reasonable assurance that the published audited financial reports are free from material misstatements and are in accordance with legislation and relevant accounting standards. Auditors' reports thus add credibility to financial information prepared and published by directors or officers. A by-product arises from constructive observations made by auditors to directors and offices based on matters which have come to the auditors' attention in the course of the audit."

This statement was issued in 2001, but it expresses views that have held good for many years. It draws attention to two particular aspects of the audit process that have central importance in relation to comment that may be made on audit in the present context: conformity with legislation, and conformity with relevant accounting standards. The claim that the audit function is necessary for the maintenance of confidence carries with it a responsibility to the public: to ensure that published standards and guidance are available where they are required. That responsibility is incumbent on the accounting professions as a whole. Protracted failure to develop necessary professional rules and practices on which the consumer of audited financial statements could rely would be a ground for serious criticism of the responsible bodies in the context of audit as in the context of accounting standards.

11. The APB has also committed itself to supporting the International Accounting Standards Committee (IASC) in its aim of improving the worldwide harmonisation of auditing practices, and formulating SASs with due regard to international developments, in particular the international auditing standards (IASs) issued by the International Auditing Practices Committee of the International Federation of Accountants (IFAC). The aim of the IFAC is improving the harmonisation of auditing practices throughout the world. In the absence of relevant IASs published by the IASB, the APB retains its domestic responsibilities for the promulgation of local standards within the APB's objectives.

Developments in Insurance Auditing

12. I have described in the last chapter the current position in relation to accounting standards for insurance entities. There are no relevant authoritative statements in relation to realistic accounting for future payments of terminal or final bonus. The audit function has, at least to some degree, been frustrated by the persistent failure to promulgate acceptable accounting standards for the industry. As discussed more fully elsewhere, I have concluded that the regulatory structure for insurance company accounting progressively lost touch with the reality of life business as it developed in the 1980s and 1990s. In my view, the auditor of a long-term insurance business has operated, over much of the period with which this inquiry has been concerned, within a flawed regulatory environment without specific guidance on fundamental accounting issues from the responsible professional bodies. This has had a bearing on all published financial statements. I shall comment on the general guidance available and the extent to which it was relevant to the performance of audit. But first, it is necessary to comment on the development of the regulatory framework so far as it bore on the scope of audit.

13. In the late 1960s and early 1970s there was extensive discussion of proposals for amendment of insurance company legislation and regulation. Among the more controversial issues were the approach to valuation of long-term liabilities, and the interaction of the roles of actuaries and auditors. The most significant issue that arose in connection with liabilities related to the practice of actuaries of including over-prudent margins in liability valuations, inflating the liabilities as a result and depressing distributable surplus. Some auditors took the view that this practice undermined the possibility that the accounts could show a true and fair view of the insurer's state of affairs, and qualified, or threatened to qualify, their reports to members accordingly. By the end of 1971, the approach to the audit of insurance accounts generally was a live issue. There was dissatisfaction in the industry with the then current requirement that the auditor should express a view on the true and

fair presentation of accounts that contained long-term business provisions that the industry, and the actuarial bodies, contended the auditor was not competent to assess. Possible solutions included an approved list of auditors, special qualifications for appointment as auditor of an insurance company, and participation in regulation by the British Insurance Association (BIA).

14. Most of the proposals were rejected summarily. On 18 January 1972, the chairman of the BIA wrote to the Secretary of State stating that the BIA could not undertake a supervisory function, or share the DTI's responsibility for supervision. No one thought insurance business special enough to justify specific audit qualifications. The idea of an approved list of auditors was rejected as impractical by the ICAEW on 25 June 1971, and again in discussions between regulators and representatives of the accounting bodies, including the then well-known and authoritative Sir Ronald Leach, in January 1972.

15. Among a range of specific topics discussed by the chairman of the BIA in his letter was the contribution that auditors could be expected to make in relation to outstanding claims reserves in general business. Except in the case of deliberate understatement, where it was conceded that the auditor had a role, his comments were dismissive. The accounting profession was clearly thought to lack actuarial expertise and therefore to have little to contribute to the authority of the financial statements of insurance entities. It is clear that one might have said the same about many other commercial and industrial enterprises that required audit. It is a measure of attitudes towards the actuarial profession, and of the regard in which it was held at the time, that the comment appears to have attracted no adverse reaction.

16. The issue was taken up in correspondence between DTI and GAD, and in internal discussions within DTI in relation to long-term business[2]. Distinctions between Companies Act accounting and accounting in regulatory returns were not highlighted, and were sometimes ignored. On 2 February 1972 Colin Stewart of GAD wrote to DTI. He expressed the view that technical reserves should be the responsibility of the actuary, and that the auditors should be excluded from having any responsibility for these reserves or the disclosure of margins included in them. On GAD's approach, as expressed by Stewart, the role of the auditor in relation to long-term liabilities should be clearly circumscribed.

17. On 28 February 1972 the Faculty of Actuaries responded to a request for comments on the protection of life policyholders. The Faculty's suggestions included strengthening the actuary's certificate under regulations 5 and 6 of the 1968 accounts and forms regulations, strengthening the resources available to DTI's insurance division and GAD, accelerating the scrutiny procedures, and improving the content of published statistics. Audit was not treated as a feature of importance.

18. On 2 March 1972 the accounting services division of DTI entered the discussion. In relation to audit, the division's view was that there was something to be said for widening the responsibility of auditors. It appears that the accounting profession had resisted the suggestion. The memo stated:

> "Under the Accounts and Forms Regulations, insurance companies are required to prepare accounts giving a true and fair view, and in order to report on these matters, auditors should have regard to the technical reserves and, thus, should review the claim frequency and claim settlement analyses. Very likely the auditors already do this in the course of forming their opinion on the true and fair view and ... the Institute is really cavilling about imposing an express obligation on the auditor to report on the matters which enter into the calculation of these particular liabilities.

[2] See also discussion of the origin of PRE in chapter 13.

> This proposal would need detailed study but, presumably the auditor could be required to include in his report a reference to any significant departure from any code of guidance which the Accountancy profession might produce."

Both extremes of opinion had now been articulated within Government.

19. The Institute of Actuaries then commented. The Institute drew attention to: "a problem which arises in distinguishing between the respective responsibilities of the auditor and actuary in completing certificates to the accounts":

> "Under paragraph 2 (1) of the Regulations it is required that the accounts prepared thereunder should give a true and fair view subject only to the proviso to that Regulation. Since this proviso refers solely to the assets, auditors may feel obliged to concern themselves with the valuation of the liabilities. On the other hand, both in Regulation 2 and in Regulation 7, the certificate required under the Regulation 5 is specifically omitted.
>
> The valuation of the liabilities is of course in the first place the responsibility of the actuary. It is then subject to external supervision by the DTI with the assistance of the GAD with its relevant professional knowledge. It is moreover outside the professional sphere of anyone other than an actuary, so that no auditor can properly be asked to be responsible for, or to supervise, the valuation.
>
> We would accordingly strongly recommend that it should be made clear that just as the "true and fair view" is subject to various provisos – such as the proviso to Regulation 2 (1), or corresponding provisos where accounts are being prepared under the Companies Act – so it should also be subject to the Actuary's valuation of the liabilities."

20. The terms of regulation 2(1), so far as they related to insurance companies that were not exclusively carrying on industrial business in the UK, were as follows:

> "The accounts of every [insurance] company ...and all statements, certificates and reports annexed thereto ... shall give a true and fair view of the state of affairs of the company as at the end of its financial year and of the profit or loss of the company for the financial year:
>
> Provided that such accounts, statements certificates and reports shall not be deemed not to give such a true and fair view by reason only of the fact that the amount at which any asset of the company has been included in the balance sheet is less than the full value of that asset."

21. A meeting between officials and the Institute of Actuaries followed on 28 March 1972. The role of the auditor was discussed. The departmental view had moved towards reducing the role of the auditor. On 10 April 1972 Cyril Homewood of DTI[3] circulated a note in these terms:

> "I am coming increasingly strongly to the conclusion that the present qualified application to insurance company accounts of the 'true and fair view' criterion is the wrong way round. Regulation 2 of the 1968 Regulations requires a true and fair view subject only to the proviso that assets may be included in the balance sheet at less than 'full' (undefined) value. By implication liabilities, including prospective and contingent ones, must be shown at a 'fair' (= prudent?) value since a true value is not normally determinable. ...
>
> ... it never made much sense to insist that there should be no fat in the amounts set aside for liabilities. We were somewhat equivocal on this... It is causing particular difficulties between auditors and actuaries because the latter value liabilities on a basis substantially stronger than the contractual commitments would require.

[3] See also chapter 13, paragraph 20 et seq.

I am not clear whether a true and fair view is to be held to exclude generous provision for uncertain liabilities or if so whether an acceptable standard of generosity could be defined. I suspect that the answer to both questions is No, so that prima facie no specific provision may be necessary to permit such generosity. It is conceivable, however, that different answers should be given for long-term business, where it may be easier to quantify the surplus over contractual commitments, and general business. ...

Thus it seems that our aim should be normal true and fair treatment of assets in insurance accounts – subject to any admissibility conditions – together with effective freedom to provide generously for liabilities in both long term and general business. ..."

22. His view was not accepted without argument. A colleague responded that he was not in favour of relaxing the true and fair standard in relation to liabilities on the ground that an unqualified opportunity to inflate liability values could be used to mask the true picture of the office's claims experience. Although the contemporary records do not deal with the point, I understand that there was in contemporary practice ample justification for the approach to assets. Actuaries frequently adopted the lower of market value and a valuation based on future maintainable dividend yield in financial statements, resulting in the amount included being 'less than the full value of the asset'. The liabilities issue was independent of that practice.

23. Homewood returned to the discussion on 21 April. In relation to the long-term fund he said:

"'The conflict between auditors and actuaries is more difficult because it is perfectly possible to calculate an overprovision for with-profits policies as regards the contractual liabilities, although even this involves acceptance of some assumptions which will invariably have been made by the actuary on a conservative basis.

The adoption of an 'adequacy' standard of solvency for long term business, possibly topped up to satisfy EEC with an explicit solvency margin, would however substantially reduce the disputed area. If there is still likely to be conflict... we may have to invent a proviso to the true and fair view requirement which removes the actuary's valuation of the liabilities from the scrutiny of the auditor.

Since we are also contemplating that the actuary would record his satisfaction with the adequacy and suitability of the assets allocated to the long term fund, possibly the auditor should be required to accept this also without question. ..."

24. On 24 April 1972 Stewart wrote to DTI. The letter set out the GAD view at the time:

"... I was alarmed to see ... that the central issue had been lost sight of, namely the conflict between actuaries and auditors on the life liabilities. ...

There is no easy answer to this: Apart from investment-linked policies where the return on the policy is constrained by the terms of the policy, the usual purpose of valuation of a life fund is two-fold. It will ensure the solvency of the non-profit business and arrange for the emergence of surplus at a particular rate in the case of with-profit business. But the amount of this surplus in any year, and its distribution between policyholders, is at the discretion of the directors of the company. In exercising this discretion they traditionally, indeed necessarily, take the advice of the actuary whose calculations will give them the necessary basis for their decision.

It is difficult to see the purpose, in these circumstances, of an attempt to provide an auditor's certificate that the amount in the life fund presents a true and fair view of a discretionary figure."

He then sketched out two possible approaches. The first was essentially the method generally employed in continental Europe, while the other was to:

"... (ii) Leave the directors their present discretion, in the exercise of which they have no alternative but to take actuarial advice. The life fund's adequacy will be covered by the actuary's Regulation 5 certificate and should be specifically excluded from the auditor's certificate. This is the solution proposed by the actuarial bodies and we support it.

Apart from the fact that auditors are not properly equipped to comment critically on what an actuary has done ... the Government Actuary's Department is properly equipped for this purpose and obtains in the statutory returns the information which enables it to carry out this task. The present obligation imposed upon the auditors (unwittingly?) in relation to the long-term liabilities is one that they cannot in practice carry out but, in so far as it is possible to put a meaning on this obligation, it is one which my colleagues and I can and do carry out in our scrutiny of the statutory returns."

He made observations about the use of asset valuation techniques to allow an orderly emergence of surplus over the years.

25. On 26 April DTI circulated an amended paper setting out the current proposals. The Institute of Actuaries had at first agreed with reluctance and then refused to prepare a note on the conflict between actuaries and accountants on the practice of holding un-quantified free reserves in the long-term funds. It was agreed that so long as the DTI did not take exception to accounts carrying a qualified audit report relating to the long-term fund, actuaries would not complain. And there the matter appeared to rest. The 1969 regulations were not amended to add a further proviso to regulation 2(1). There was no separate provision. The valuation of assets was dealt with in detail in 1974[4]. Freedom to vary investment valuation was restricted. But liabilities were left untouched.

26. There was some further activity on the sidelines. The *Accountant* dated 11 May 1972 published the text of the representations made by the ICAEW to DTI in June 1971 in which, inter alia, they sought guidelines on the proper conduct of certain aspects of insurance companies' audits. This attracted a response from Stewart in a letter to Homewood on 23 May. It is sufficient to note his comment that:

"'Guidelines' are not required in life assurance, of course, because there is actuarial certification and what O'Brien of the LOA[5] calls 'actuarial auditing by GAD'."

27. The role of the auditor was discussed at a meeting held on 5 July 1972 at which the accountancy bodies were represented. It was noted:

"Regarding the role of the auditors in estimations of provisions Mr Ansell [representing the accounting bodies] said that an auditor could only be as good as the person making the estimates. The auditor could not do much more than satisfy himself that the system of estimation was satisfactory. There was room for some education of auditors in this role."

The accounting bodies appeared to accept the position for which the actuaries had been contending: there was no obvious enthusiasm for wider audit responsibilities at that stage.

[4] The Insurance Companies (Valuation of Assets) Regulations 1974, SI 1974/2203.

[5] The Life Office Association.

28. DTI prepared a note of progress to 5 July 1972, summarising emerging conclusions in relation to general business. In relation to auditors it was said:

> "Auditors cannot be expected to verify in detail the adequacy of the provisions made for outstanding and prospective claims. They may reasonably be expected to satisfy themselves that the recording systems and the methods used for estimation... are sound and properly operated; some guidance in this and possibly other aspects of the returns may be desirable for auditors with limited experience in auditing insurance accounts."

29. On 17 August 1972 Stewart circulated proposals for amendment of the primary legislation and regulations in the light of discussions to that point. He covered a range of detailed points. In particular he recommended the amendment of the regulations to provide that the auditor need not be concerned with long-term liabilities that were certified 'adequate' by the actuary. That suggestion was not taken up. The more pragmatic solution of ignoring any qualification in the auditor's report appears to have been adopted.

30. The position from 1968, under paragraph 2(1) of the accounts and forms regulations, had been, therefore, that the 1948 requirement that a true and fair view be presented was modified in relation to assets. It was recognised by the regulators that there should be a qualification of the auditor's reporting obligations to make it clear that the auditor was not concerned whether the long-term liabilities reflected a true and fair view in reporting on the accounts. The amendments were not introduced, but practice was influenced.

31. In practical terms, the form of the audit report required by the 1968 regulations could accommodate a regulatory derogation in respect of liabilities as it could in relation to assets. Regulation 7(2) required the report to state whether or not, in the auditor's opinion, the accounts and the statements and reports annexed thereto had been properly prepared in accordance with the provisions of the regulations and whether or not it was reasonable for the persons giving the certificates annexed to the accounts to have arrived at the opinions they contained.

32. The position is illustrated in the Society's accounts. In the 1966 accounts the report of the auditors included the paragraph:

> "In our opinion proper books have been kept by the Society and proper returns received from branches and the accounts, which are in agreement therewith, comply with the Companies Act 1948, in the manner authorised for assurance companies which, under the Act, are not required to show separately reserves and provisions, the movements therein or the market value of investments and on such basis give a true and fair view of the Society's state of affairs at 31 December 1966, and of the transactions for the year."

In the 1967 accounts the equivalent paragraph was:

> "In our opinion the Society's balance sheet and revenue accounts have been properly prepared in accordance with the provisions of the Companies Act, 1948, in the manner authorised for assurance companies."

33. In the 1968 accounts a reference to the Companies Act 1967 was introduced, but the report was otherwise the same. In the 1969 accounts the report was more elaborate, and reflected the terms of the 1968 regulations:

> "In our opinion the Society's balance sheet, revenue account and related statements comply with the Companies Acts 1948 and 1967 in the manner authorised for assurance companies and have been properly prepared in accordance with the provisions of The Insurance Companies (Accounts and Forms) Regulations 1968, applicable to long-term business.
>
> Further, we consider that [the directors'] certificates ... on the balance sheet have been properly prepared in accordance with the Regulations and that it

was reasonable for the Society's officers to have arrived at the opinions therein stated."

34. For all practical purposes the position remained the same until the Companies Act 1985 (Insurance Companies Accounts) Regulations 1993 came into effect in respect of financial years commencing on or after 23 December 1994. (The Society adopted the new regulations for 1994 voluntarily.) The accepted view until then was that[6]:

> "In respect of the financial statements of a special category company (other than one that is not entitled to benefit from, or that has not taken advantage of, the exemptions from Part I of Schedule 9 to the Act that are set out in Part III of that Schedule), the auditors are *not* required to report whether, in their opinion, the balance sheet and the profit and loss account give a true and fair view both of the state of the company's affairs at the end of the year and of the company's profit or loss for the period. However, they must still report whether, in their opinion, the balance sheet and the profit and loss account have been properly prepared in accordance with the Act [Sec 262]."

Audit Reliance and Dependency on the Work Performed by the Actuary

35. The limited scope of audit up until 1995 was therefore the result of a policy decision taken in the early 1970s, fully informed by consultation with GAD, the industry and the professions, that secured the actuary's control over the quantification of the long-term fund effectively to the exclusion of challenge by the auditor on true and fair grounds.

36. This was a significant factor, and materially affected attitudes to audit. The surplus in any year, the profit of a general company, was not a function of the current activity of the organisation expressed in terms of accounting principles. The surplus was essentially a function of balance sheet values, a difference between assets at or below market value, substantially if not wholly based on objective criteria, and the actuarially determined liabilities of the office. The liabilities of a life office were typically based on contracts of long duration. Measurement of surplus increased in complexity with projected duration. Significant liabilities accumulated over the duration of contracts, and required valuation based on a number of assumptions, which further complicated both the valuation process, and the measurement of profit. Most of a life office's value was represented on balance sheet by large liabilities matched by underlying investments while the level of value flowing through the income statement was significantly lower. Actuarial control over the emergence of surplus in order to smooth reversionary and terminal bonus allocations, which was seen as core to achieving policyholders' reasonable expectations, was generally held to involve considerable subjective judgment. Overarching considerations of the scope and application of the regulatory solvency rules applicable to life offices, which affected the level and nature of bonus allotments that could be made, added a further layer of complexity.

37. It appears that the accounting and auditing profession, recognising these complexities within life business, did not challenge the paramount importance of the actuary's role in liability valuation. Prior to the early 1990s, auditors relied almost totally on the work of the actuary in computing the long-term business liability. In practice, auditors would perform some high level testing in the form of corroborative inquiry and discussion with the responsible actuary. But the auditor did not verify the quantification of the liabilities as such.

38. Auditing guidance reflected this approach. Technical releases were issued in 1979 (TR 373) and 1984 (TR 568). TR 373 did not require the auditor to express an opinion on the amount of the actuary's valuation but stated that the auditor "should

[6] Accounting Provisions of the Companies Act 1985: Johnson & Patient, paragraph 13.103, page 332.

understand, as a reasonable person but not as an expert, the objectives which an actuary will have in mind" in performing a financial condition investigation, and should, inter alia, before giving the audit opinion, consult with the actuary in order to obtain reasonable assurance as to the adequacy of the assets to meet the related liabilities. TR 568 gave essentially the same advice to auditors, updated for intervening changes in legislation.

39. In October 1991, the APC issued auditing guidance 311 (AG 311)[7] which had the approval of the DTI. This document was intended to provide guidance on the special factors to be considered in the application of auditing standards to the audit of life insurers. It gave guidance on planning the audit; the premium cycle; the claims cycle; valuation of long-term liabilities; insurance debtors and creditors; and reporting. The guidance, expressing the position at 31 December 1990, stated:

> "As a result of the use of disclosure exemptions, the audit objective, as regards the balance on a life fund which contains undisclosed reserves, is to be satisfied that it is at least sufficient to meet liabilities to the policyholders whereas, if disclosure exemptions were not utilised, the audit objective would be to be satisfied that not only was it sufficient but also that it was not demonstrably excessive."

The auditor was implicitly expected to understand not only the objectives of the actuarial valuation but also something of the basic valuation process.

Audit of the Regulatory Return

40. AG 311 contained more detailed guidance in relation to the valuation of long-term liabilities than earlier publications. It indicated that the determination of the amount of long-term insurance liabilities for regulatory purposes was the responsibility of the actuary but that there was no corresponding responsibility in relation in relation to financial statements prepared in accordance with the requirements of the Companies Acts. In respect of the latter, the guidance stated:

> "However, for the purposes of expressing an opinion on the financial statements in accordance with the Companies Act, the auditor takes full responsibility for expressing an opinion on the financial statements including the amount of the long term fund."

It added that:

> "The [actuarial] principles or the assumptions may have to be varied from time to time to ensure that an adequate standard of providing for liabilities can be maintained in changing conditions and that surpluses can be released equitably as between shareholders and the different classes and generations of policyholders. In any event, the determination of the amount of long term liabilities for the purposes of the Insurance Act will have to satisfy the minimum standards laid down in the 1981 Regulations in 'making proper provision for all liabilities on prudent assumptions in regard to the relevant factors'.

The guidance set out an analysis of the factors that would require to be taken into account in determining the amount of long-term liabilities, and pointed to the guidance issued by the Institute and Faculty of Actuaries and by GAD.

41. AG 311 therefore clearly acknowledged the difference in approach to the two published financial statements required of a life office. This was a significant development in recognition of duties in relation to the Companies Act accounts. Section 21 of the Insurance Companies Act 1982 (audit of accounts) stated that the

[7] AG 311: Life Insurers in the United Kingdom, APC October 1991.

"accounts and balance sheet of an insurance company shall be audited in a prescribed manner as determined by the Companies Act."

42. The guidance contained in AG 311 set out the auditors' responsibilities in this regard. In outlining the auditor's responsibilities in terms of regulatory returns to be submitted to the DTI in accordance with section 21, the guidance stated that the auditor's responsibilities were:

> "to state whether, in his opinion, the parts of the Return required to be audited have been properly prepared in accordance with the regulations; and
>
> to state whether, in his opinion, and according to the information and explanations he has received:
>
> - the directors' certificate has been properly prepared in accordance with the regulations; and
> - it was reasonable for the persons giving certification to have made the statements therein."[8]

The standard auditor's report acknowledged reliance on the certificate of the actuary with respect to mathematical reserves, the required minimum margin, and the identify and value of any implicit items as admitted in accordance with the insurance companies regulations[9]. In this context there was no requirement that a true and fair view be presented.

43. Certification was central to the support of regulatory returns. It is not necessary for present purposes to discuss the development of the relevant requirements over time. Regulation 25 of the Insurance Companies (Accounts and Statements) Regulations 1996[10] provided for a certificate by the appointed actuary relating to the periodical actuarial valuation and compliance with schedule 4 and forms 46 to 49 and 51 to 58 of those regulations. The directors were not required to grant certificates in respect of the schedule and these forms. They were, however, required to grant certificates relating to form 9, the regulatory balance sheet and supporting forms, and forms 20 to 45 relating to the revenue account. The auditors' report had to cover the regulatory balance sheet and revenue account, but not the areas within the scope of the appointed actuary's obligations . The balance sheet included the mathematical reserves. But part III, paragraph 10(c) of the schedule only required the auditors to indicate the extent to which they had relied on the actuary's certificate with respect to the mathematical reserves and required minimum margin of the company. Similarly the auditors' report had to indicate the extent to which they had relied on the actuary's certificate in relation to implicit items included in form 9.

44. As at the end of the reference period, therefore, the auditor was entitled to rely on the appointed actuary's certificate in reporting on the regulatory balance sheet in particular, subject to disclosure of the extent of the reliance. Ernst & Young relied on the appointed actuary's certificate. In the 2000 returns they stated:

> "In giving our opinion we have relied on:
>
> a) The certificate of the actuary on page 326 with respect to the mathematical reserves and the required minimum margin for long-term business.
>
> b) The identity and value of implicit items as they have been admitted in accordance with regulation 23(5) of the Insurance Companies Regulations 1994, by virtue of an Order issued under section 68 of the Act on 13 September 2000 and to the extent indicated in note 0902."

[8] AG 311, para 97.
[9] Currently the Insurance Companies Regulations 1994, regulations 23 (5) and regulations 24 to 26.
[10] SI 1996/943.

The actuary certified, inter alia:

> "(ii) that the mathematical reserves as shown in Form 14, together with an amount of £1,500 million (being a part of the excess of the value of admissible assets representing the long term business funds over the amount of those funds shown in Form 14) constitute proper provision at 31 December 2000 for the liabilities (other than liabilities which had fallen due before 31 December 2000) arising under or in connection with contracts for long term business including the increase in those liabilities arising from the distribution of surplus as a result of the investigation as at that date into the financial condition of the long term business; and
>
> (iii) that for the purpose of sub-paragraph (ii) above the liabilities have been assessed in accordance with Part IX of the Insurance Companies Regulations 1994 in the context of assets valued in accordance with Part VIII of those Regulations, as shown in Form 13;"

45. The position therefore was that, for regulatory purposes, the auditor disclosed reliance on the actuary's certificate that the mathematical reserves were a proper provision for long-term liabilities, taking into account any implicit items.

46. In 2000, the practice of over-distribution was recognised. The actuary's certificate stated, in addition to the paragraphs quoted above, which were of a standard type:

> "(vi) The bonus system operated for accumulating with-profits business identifies the present "policy value" which will be paid where a contractual claim arises. This is a combination of a guaranteed fund and a final bonus amount. The final bonus amount can be altered at any time. At 31/12/2000 total policy values were in excess of the available with-profits assets.
>
> At the date of the signing of these returns equity markets have fallen in value from the year-end levels whilst policy values have continued to rise at the interim final bonus rate of 8% per annum.
>
> Where appropriate the Society has recognised this position in its application of a Financial Adjustment to reduce non-contractual claims amounts.
>
> In view of the projected contractual claims out flow over the next few years, policy values also need to be adjusted to reflect the assets available.
>
> Bonus policy is currently being considered by the Board and these Returns are prepared on the assumption that appropriate action will be taken in the near future."

This additional material could only have been provided in the actuary's certificate in terms of paragraph 9 of schedule 6 to the 1996 regulations as material that the appointed actuary considered 'necessary' to provide in qualification, amplification or explanation of his certificate. Superficially, and leaving aside the state of the markets, the factors identified would have been relevant to any period from 1987 onwards.

47. AG 311 was superseded, and interim guidance (referred to below in the context of audit for Companies Act purposes) was consolidated, in practice note 20 (PN 20)[11], issued by the APB in August 1999. This document was prepared in consultation with the FSA and Lloyd's. PN 20 differed in approach from AG 311, in that it provided guidance on all current auditing standards by demonstrating their application to the specific requirements in the case of an insurer. The document incorporated material from a wide range of pre-existing statements.

48. PN 20 expanded and provided additional guidance to auditors on their responsibilities for reporting on regulatory returns. The auditor had to express:

[11] PN 20: The Audit of Insurers in the United Kingdom.

> "i. an opinion as to whether Forms 9 to 17, 20 to 45 (including supplementary notes thereto) and the statements furnished pursuant to regulations 19 to 21 and 23 have been properly prepared in accordance with the provisions of the 1996 Regulations;
>
> ii. an opinion on the directors certificate; and
>
> iii. the extent to which the auditors have relied, in giving their opinion, on the actuary's certificate with respect to the mathematical reserves and required minimum margin for long-term business and on the identity and value of implicit items included in the Return."

In addition to these requirements the auditor was required to report by exception on the maintenance of adequate accounting records and other matters specified by section 237 of the Companies Act 1985 (regulation 29).

49. PN 20 described additional procedures required to be carried out by auditors over and above those undertaken by them to report on the financial statements. These were:

i. the application of the prescribed valuation and admissibility rules to assets and liabilities for which existence, title, etc. had already been considered as a part of the audit of the insurer's financial statements;

ii. the sub-division of general business revenue information into accounting classes, business categories and risk groups;

iii. presentation of the information in the prescribed forms; and

iv. the specific additional disclosures that fell within the scope of the auditors' report.

50. Paragraph 16 stated:

> "The 1996 Regulations draw a clear distinction between those parts of the Regulatory Return which are required to be referred to in the auditors' report and those which are not. A significant example of the latter which is of particular importance for a company transacting in long-term business is the abstract of the Appointed Actuary's valuation report prescribed by Schedule 4 to the 1996 Regulations. The fact that the auditors' responsibilities do not extend to this part of the Regulatory Return is reinforced by Part III of Schedule 6 which enables the auditors in their report to express reliance on the actuary's certificate for the mathematical reserves and required minimum margin figures which are derived from Schedule 4. Where auditors avail themselves of the entitlement, they are required to state in their report on the Regulatory Return the extent to which they have relied on the certificate given by the Appointed Actuary. In such circumstances, it is not necessary for the auditor to read the parts of the Return falling outside their report, and their report on the Regulatory Return does not provide assurance on the Appointed Actuary's assessment of the mathematical reserves in the Regulatory Return, nor on any other matters included in the actuarial certificate."

51. PN 20 discussed the 'reasonable expectations of life policyholders', stating:

> "In determining liabilities, the appointed actuary is required to take into account the reasonable expectations of policyholders."

The section concluded by stating that the primary responsibility for calculating the mathematical reserves and for assessing the reasonable expectations of the policyholders lay with the appointed actuary. However it stated:

> "It is possible that, in reviewing the scope and nature of the actuarial investigation in connection with the audit, auditors may become aware of concerns of the appointed actuary in respect of reserving for policyholders' reasonable expectations. In such circumstances, auditors ought normally to

discuss the matter further with the appointed actuary to establish whether there are any matters, which give rise to a duty to report to the Insurance Directorate."

52. This was said against a background of change in regulations. The Auditors (Insurance Companies Act 1982) Regulations 1994[12] dealt with the auditor's duties to communicate with the Secretary of State circumstances that gave the auditor reasonable cause to believe that they were or might be of material significance for determining whether any powers of intervention conferred by the Secretary of State by sections 38 to 45 of the 1982 Act should be exercised. Section 45, provided a catch-all or residual power to impose requirements for protection of policyholders:

- To protect policyholders and potential policyholders against the risk that the company may not be able to meet its liabilities or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders; or
- To ensure that the criteria of sound and prudent management are fulfilled with respect to the company.

The auditor now had a more precisely defined obligation to concern himself with liabilities, and with policyholders' reasonable expectations, among other factors.

53. On this analysis, the guidance set out in PN 20 reflected material developments in professional thinking about the scope of audit of the regulatory financial statements of long-term insurers. But at the end of the day, the auditor was entitled to rely on the appointed actuary's certificate in relation to the mathematical reserves, subject to disclosure that that had been the basis of the audit report. The treatment of policyholders' reasonable expectations in the guidance reflects a more fundamental subordination of the auditor's role to that of the appointed actuary, notwithstanding the 1994 Regulations. Paragraph 38 of the guidance emphasised the primary responsibility of the actuary. The auditor's role depended on the possibility of becoming aware of concerns that the actuary might have in respect of reserving for policyholders' reasonable expectations. I have already commented on the difficulties arising from the distinction between recognising and quantifying a liability in this context. But for present purposes it is more material that the auditor's role was reactive to the appointed actuary's concerns: it was not defined in terms of independent initiative. That impression was reinforced by the reminder that the appointed actuary had a professional duty in terms of GN1 to report to the DTI insurance directorate in certain circumstances. Ernst & Young's 2000 audit report annexed to the regulatory return reflected the extent of the audit function at that stage.

Audit of the Companies Act Accounts

54. AG 311 set out the objectives of the auditor in relation to the Companies Act accounts. The focus was on the office's long-term liabilities. The primary objective was to obtain reasonable assurance that the assets of the long-term fund were not less than the related liabilities. In relation to ascertained surplus, it was an objective to establish whether either its amount or the proportion distributed to shareholders had been materially affected by a change in the valuation approach or assumptions or by exceptional circumstances that might require disclosure in the financial statements, having particular regard to the provisions of paragraph 28(1) of schedule 9 to the Companies Act. The guidance required the auditor to consider any relevant reports made to the directors by the actuary and to discuss with him matters relevant to the valuation of long-term liabilities. In terms of the guidance, the audit approach should be sufficient to ascertain, inter alia: that existing systems procedures and controls generated reliable valuation data consistent with the

[12] SI 1994/449.

accounting records; that the valuation data was processed and co-ordinated in the valuation and certification process; that the actuary was prepared to give the regulatory certificate and would give similar comfort, if required, with regard to the financial statements for the purposes of the Companies Act; that the extent of disclosures in the financial statements was consistent with a true and fair view; and to show the quantum of free reserves.

55. Auditors were additionally required under this guidance, to establish from reports to the directors by the Actuary, augmented as appropriate by consultation with the Actuary, whether

> "...
>
> - the distributions have been made out of the established surplus;
> - any participating policyholders have received not less than their minimum entitlement under the insurer's statutes; and
> - the transfers to profit and loss account from surplus in which participating policyholders are eligible to participate are not such as to require the company to give notice to the Secretary of State under section 30 of the Insurance Act."

Accordingly for 1992 and subsequent years there were material developments in the nature and the scope of professional guidance on audit. The guidance relating to liabilities did not expand on the relevant accounting statements and standards. Despite its terms, therefore, the effectiveness of the audit guidance was qualified by the concentration on contractual or guaranteed liabilities inherent in the accounting approach. Further, the emphasis remained on process. In substantial matters the auditor remained dependent on the actuary in relation to liability valuation. In particular, the guidance did not require the auditor to satisfy himself by independent computation or checking of the quantification of the office's technical provisions.

56. It is necessary to see the position in the context of wider developments over the material period. There were developments in the approach to audit generally from the mid 1980s, accelerating from the early 1990s. From about the beginning of the 1990s there was movement away from the earlier preferred approach which was based on tests of detail looking at source documentation and tracing this into the general ledger, which was ultimately used to prepare the annual accounts. The approach changed towards a top-down risk-based analysis, which focused on high-level industry specific issues used to identify associated risks, which would then have to be dealt with specifically in the audit. At a planning stage the auditor would identify the relevant risks and design appropriate procedures to assess the potential for material error to occur and remain undetected by management. In the case of insurance audit, the changed approach was reflected in the employment of in-house actuaries as part of the audit team. The actuaries' function was to challenge and test the assumptions used by the actuary in accordance with developing guidance. This resulted in more rigorous testing of the work performed by the actuary. The accounts directive of 19 December 1991 had to be implemented by the adoption of appropriate laws regulations and administrative provisions by 1 January 1994 for application in 1995. In AG311 there was recognition that European requirements would drive change in the scope of and approach to audit. In some respects, AG311 anticipated the changes that would come on implementation of the accounts directive.

57. It is unnecessary for present purposes to note at any length the development of regulations over the early 1990s. The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993; Insurance Companies Regulations 1994, the Insurance Companies (Amendment) Regulations 1994; the Companies (Summary Financial Statement) Regulations 1995; and the Insurance Companies (Accounts and Statements) Regulations 1996 in their several ways changed the regulatory context

in which audit had to operate both in relation to regulatory returns and in relation to Companies Act accounts. Professional guidance in each context was published in response to changing requirements.

58. In Ernst & Young's submission to the inquiry, the position in relation to Companies Act accounts prior to 1995 was described as follows:

> "Due to the disclosure exemptions, insurance companies were allowed to understate their assets and report the long-term business fund as a single item in the balance sheet. The audit was therefore not required to consider the amount of policyholder liabilities as a separate item in the balance sheet or to express an opinion in 'true and fair' terms. However, the Companies Act Accounts of insurance companies were required to show a true and fair view subject only to the exemptions available under the Act. The auditor was therefore required to obtain reasonable assurance that the assets of the fund were sufficient to meet the related liabilities and this involved some consideration of the valuation. This practice was reflected in the contemporaneous auditing guidelines."

The submission reflected precisely the guidance in AG311. The position began to change for 1995 and later accounting periods.

59. Audit guidance was developing at the same time. SAS 420[13] and SAS 520[14] dealt with certain key areas in relation to the audit of liability valuation. SAS 420 provided specific guidance on the audit procedures to be carried out when auditing the long-term technical provision. SAS 520 provided additional guidance in this area but went on to deal with and provide guidance on the relationship and responsibilities of the auditor and actuary. In terms of SAS 420, the auditor was required to review the appropriateness of the actuarial assumptions used and the calculation of the provision. SAS 520 stated that the auditor should give consideration to the assumptions and methods used by the actuary and to the reasons for any changes in the assumptions and methods compared with those used in the prior year.

60. Paragraph 17 of SAS 420, on long-term insurance, stated:

> "The auditors seek to obtain evidence as to the appropriateness of the long-term technical provision for the purposes of giving a true and fair opinion on the financial statements. Audit procedures may include a review of:
>
> - The appropriateness of the assumptions used;
> - The controls and procedures to ensure the completeness and integrity of the data; and
> - The calculation of provisions."

61. SAS 420 also included a crucial audit step, which required the auditor to review the analysis of the surplus performed by the client to the extent that it was carried out on an annual basis. This step highlighted any divergence of actual experience from that previously assumed in the actuary's calculation and thus provided the auditor with evidence to assess the reasonableness of the assumptions adopted by the office and its actuary.

62. SAS 520 identified limitations on the scope of the auditor's investigations. Paragraph 4 noted that auditors' education and experience enable them to be knowledgeable about business matters in general, but that they were not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation. Reliance on qualified opinion was inevitable in such circumstances. But there was a realistic recognition of difficulties over

[13] SAS 420: Audit of Accounting Estimates, issued in March 1995.

[14] SAS 520: Using the Work of an Expert, also issued in March 1995.

competence and objectivity where the expert giving the opinion was employed by the entity being audited. Some specific items were highlighted:

i. Paragraph 13 stated: "If the auditors are concerned about the competence or objectivity of the expert they may discuss their reservations with management or the directors and consider whether sufficient appropriate audit evidence can be obtained."

ii. Paragraph 16 stated that in assessing the work of an expert: "The auditor should assess the appropriateness of the expert's work as audit evidence regarding the financial statement assertions being considered.

iii. Paragraph 17 developed the point: "This involves assessment of whether the substance of the expert's findings is properly reflected in the financial statements or supports the financial statement assertions, and consideration of:

a. The source of data used;

b. The assumptions and methods used;

c. When the expert carried out his work;

d. The reasons for any changes in assumptions and methods compared with those used in the prior period; and

e. The results of the expert's work in the light of the auditors overall knowledge of the business and the results of other audit procedures."

63. PN 20 again re-defined the wider context for the auditor's duties and responsibilities. Paragraph 4 of PN 20 stated:

"In applying the requirements of SAS 520 to technical provisions of an insurer computed, or reported thereon, by an actuary, auditors give particular attention to:

(a) the formal lines of responsibility defined by the insurer, between the board of directors or managing agent and the actuary;

(b) the independence of the actuary, his knowledge of the portfolio of business for which provision is being made and his experience of the market in which the insurer operates;

(c) the role of the actuary whose work they aim to use and the scope of the work undertaken. The actuary's work may be performed in accordance with regulatory or legal requirements or specific engagement instructions; and

(d) the approach which the actuary propose to adopt in calculating provisions."

Paragraph 6 stated:

"In assessing the appropriateness of the actuary's work as audit evidence, auditors may consider it appropriate to:

(a) make enquiries regarding any procedures undertaken by the actuary to establish whether the source data used is relevant, sufficient and reliable;

(b) review or test data used by the actuary; and

(c) assess the assumptions and computations used including the reasons for any changes in assumptions or computations compared with those used in prior periods."

64. Paragraph 10 sets out the Companies Act requirements of the actuary to compute the long-term business provision. The statement recognised that usually the long-term business provision in the Companies Act accounts was derived from the mathematical reserves established by the appointed actuary for the purposes of the regulatory return. Auditors were advised to consider the appropriateness of this amount for use in accounts that were required to meet the true and fair criterion.

65. The 1982 Act and the 1996 Regulations did not require the regulatory returns to be drawn up to show a true and fair view. Regulation 5 of the 1996 Regulations required that the return: 'shall fairly state the information provided on the basis required by these Regulations'. The requirement to consider the interaction of the separate tests had particular relevance in the context of the actuarial practice of including general reserves in the long-term business provision.

66. Until implementation of the insurance accounts directive[15], the existence of undisclosed reserves in insurers' accounts implied that insurers did not present a true and fair view in their annual financial statements. The effects of the directive, in summary, were:

i. Removal of "undisclosed reserves" from the long-term business fund.

ii. Permitting acquisition costs of new business to be deferred and written off over the life of the policy.

iii. The requirement to maintain a fund for future appropriations ("FFA").

iv. Requirement for a uniform set of accounts.

v. Specified accounting and valuation rules.

vi. Accounts to achieve a true and fair view.

The most fundamental impact that the directive had resulted from the final item: the requirement that the accounts are prepared on a "true and fair" basis. The standards and guidance that were in the course of development related to this requirement in particular.

67. Since 1995, the audit of insurance accounts has come closer to the general standard. In their most up-to date expression, the objectives and general purposes of audit are set out in SAS 100[16]. The statement sets out to establish standards and provide guidance on the objective and principles governing the audit of financial statements. The objective is to enable auditors to give an opinion on those financial statements taken as a whole and thereby to provide reasonable assurance that the financial statements give a true and fair view and have been prepared in accordance with relevant accounting and other requirements:

"In undertaking an audit of financial statements auditors should:

(a) carry out procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards contained in SASs, to determine with reasonable confidence whether the financial statements are free of material mis-statements;

(b) evaluate the overall presentation of the financial statements, in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and

(c) issue a report containing a clear expression of their opinion on the financial statements."

[15] Council Directive 91/674/EEC.

[16] SAS 100: Auditing Standards and Guidance for Members, issued by the APB, para 1-6 of 3.100. Effective date: periods ending on or after 23 December 1995.

68. In general, financial statements are directed primarily towards the information needs of an entity's shareholders, proprietors or equivalent body of person (in the case of a mutual its with-profits members) prepared with the objective of meeting the true and fair requirement. A degree of imprecision is inevitable in the preparation of all but the simplest of financial statements because of inherent uncertainties and the need to use judgment in making accounting estimates and selecting appropriate accounting policies. Accordingly, financial statements may be prepared in different ways and still present a true and fair view. The user cannot assume that the auditors' opinion is a guarantee as to the future viability of the entity, nor that it provides assurance as to the efficiency or effectiveness with which management has conducted the affairs of the entity. The purpose of an auditor's opinion is to enhance the credibility of the financial statements by providing reasonable assurance from an independent source that they present a true and fair view. The responsibility for preparing and presenting financial statements rests with the directors of that entity. The auditor's responsibility is to express an opinion on the financial statements, not to relieve the directors of any of their responsibilities.

69. The scope of the work required to conduct an audit in accordance with the auditing standards contained in SASs is determined by the auditor. Factors which influence auditors' judgments in this regard include the requirement of, and the guidance contained in, SASs, the requirements of relevant professional bodies, legislating and regulations and the terms of the audit engagement. The auditor gains statutory powers from the Companies Acts. Insurance business is governed by schedule 9A to the Companies Act 1985 which sets out the requirements for the form and content of company accounts.

70. While an audit must be conducted in accordance with the SASs issued by the APC and the APB, the quality of an audit is very much dependant on the auditor having sufficient appropriate knowledge of his client's business, and being able to exercise his professional judgment in areas of subjectivity. And, the success of an audit is also dependant on the robustness of the accounting and other applicable standards in force at a particular time. If there is no accounting standard that requires a particular transaction to be accounted for or treated in a specific manner in the first place, the auditor will have no specific guidance or justification in dealing with complex issues in a manner which may more appropriately support his views even though he has carried out all necessary audit procedures indicated by general guidance.

Duty to Report to Third Parties

71. The auditor has clearly defined obligations to report to regulatory and other authorities. Section 21A of the 1982 Act[17] states that an auditor's professional duties will not be breached if he communicates in good faith to the Treasury or Secretary of State, whether in response to a request from them, any information or opinion on a matter of which the auditors has become aware in his capacity of auditor. The Act permits the auditors' professional body to issue such guidance on matters deemed relevant to disclose.

72. Paragraph 112 of AG 311[18] set out the position at December 1991:

> "In exceptional circumstances, where it is in the interests of protecting existing and prospective policyholders that the management of the insurer should not be informed in advance, the auditor should report directly to the DTI. In the case of an insurer carry on long-term business, it may still be

[17] Section 21A, communication by auditor with [Treasury or] Secretary of State, was inserted by the Financial Services Act 1986. Regulations were made under the provision in 1994 (SI 1994/449) and modified as part of implementation of the 'Post-BCCI Directive' in 1996 (SI 1996/1669).

[18] Paragraph 112: Reporting Directly to the DTI, AG 311.

appropriate to discuss the matter with the Actuary. Examples of such circumstances are:

- where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, ...
- where there has been an occurrence which causes the auditor no longer to have confidence in the competence of the directors or senior management to conduct the business of the insurer in a prudent manner so as to protect the interest of existing and prospective policyholders..."

The guidance went on to state that:

> "a direct report should be made where the insurer or, where appropriate, the Actuary will not themselves inform the DTI of a matter, having been advised to do so by the auditor or where they have done so within the period of time specified, or where there is not adequate evidence that the insurer or the Actuary has properly reported the matter in question."

73. The position has developed. SAS 120[19] provides in paragraph 2

> "Auditors should plan and perform their audit procedures, and evaluate and report on the results thereof, recognising that non-compliance by the entity with law or regulations may materially affect the financial statements."

Paragraph 56, which deals with reporting to third parties, states:

> "When the auditors become aware of a suspected or actual non-compliance with the law and regulations which gives rise to a statutory duty to report, they should make a report to the appropriate authority without undue delay.

74. More particularly, SAS 620[20], which deals with the auditors' right and duty to report to the regulators, provides (in paragraph 2) that:

> "Auditors of regulated entities should bring information of which they have become aware in the ordinary course of performing work undertaken to fulfil their audit responsibilities to the attention of the appropriate regulator without delay when
>
> (a) they conclude that it is relevant to the regulatory functions having regard to such matters as may be specified in statute or any related regulations; and
>
> (b) in their opinion there is reasonable cause to believe it is or may be of material significance to the regulator."

In paragraph 14 the term 'material significance' is explained as follows:

> "the term material significance requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator's functions when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator."

75. PN 20 provides additional guidance to the auditor with respect to his responsibilities under this section in Appendices I and II.[21] Matters likely to be of material significance to the regulator, the insurance directorate of DTI at the time, and therefore give rise to a duty to report, fall under the following categories:

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[19] SAS 120: Considerations of law and regulations.

[20] SAS 620: Auditors' right and duty to report to regulators in the financial sector, issued March 1994.

[21] Appendix I: Criteria for Sound and Prudent Management sets out situations which may be regarded by the audit to constitute a breach of this requirement. Appendix 2: Matters of Material Significance: Insurance Companies provides guidance to the auditor.

(a) matters that could lead to the withdrawal of the insurance company's authorisation;

(b) matters indicating a failure to comply with the criteria for sound and prudent management;

(c) matters indicating that a contravention of any provision of the 1982 Act that is likely to be of material significance;

(d) matters that indicate that the insurance company's continued functioning is in doubt;

(e) matters indicating that the insurance company's financial statements or regulatory return have not been properly prepared, leading to the auditors' decision to issue a qualified opinion.

A solvency margin breach indicates that a "deterioration in the solvency position of an insurer may constitute a matter of material significance and so trigger a duty to report".

76. The auditor's independent obligation to report to the regulator could, in appropriate circumstances, involve investigations into the reserving policies and practices of the actuary. But the obstacles in the way of the auditor have at all material times been serious. For example, SAS 620 provides for direct report where the auditor has concluded that circumstances have been identified that are relevant to regulatory functions "having regard to such matters as may be specified in statute or any related regulations"; and to have formed the view that the circumstances are likely of themselves to require investigation by the regulator. The auditor would require to form a view of the scope of the relevant statutory and regulatory requirements in the circumstances, of the relevance of the circumstances to the regulator, and of the probability of the need for investigation by the regulator. The circumstances justifying this approach are likely to be extreme.

77. A difference of opinion over providing for terminal or final bonus in advance of a claim would not fit clearly into the range of guidance provided. In general the emphasis on liabilities, interpreted in accordance with accounting standards and guidelines, would have left this area uncovered.

Conclusion

78. In summary, then, the position remained generally static between 1968 and about 1995. AG 311 saw the beginning of a process of change, but it was only mid-decade that the regulatory framework and the supporting professional guidance had become firm and provided a basis for a more developed approach to insurance audit. Even then the lack of appropriate accounting standards meant that the auditor was deprived of one of the main planks from which to develop the approach to auditing insurance companies accounts.

79. As already stated, it is not within the remit of this inquiry to attempt to formulate the scope of auditors' duties or to identify and comment on issues of negligence or breach of duty. The factors I have identified as relevant to the general position as it developed over the period I have reviewed, and to the discussion of lessons to be learnt for the future, may be irrelevant to, or fail fully to explore matters that would be relevant to, the resolution of disputed issues of breach of duty.

80. The following chapter sets out a review of the factual findings derived from Ernst & Young's audit files relating to the audit of the Society between 1990 and 2000. Statements received from members or employees of Ernst & Young have supplemented the written record. The inquiry's approach to the evidence reflected in

the analysis has been to consider its bearing on other sources of evidence relating to the Society's position over time. It has not been influenced by analysis of the issues raised in the current litigation, and is not intended to imply views on the questions of fact focused in the pleadings in the case against Ernst & Young.

CHAPTER 12: ERNST & YOUNG'S AUDIT OF THE SOCIETY

1. The inquiry has had access to, and has reviewed in detail, the audit files maintained by Ernst & Young in relation to the Society from 1990 to 2000. It would be of little value to report in full the terms of the comprehensive analysis that has resulted from that exercise. It has informed the investigation, and together with the regulatory material recovered has been of considerable assistance in confirming the relevance of lines of inquiry that had been identified otherwise. Much of the audit material would show due diligence on the part of the audit team in developing a relevant level of knowledge of the client's activities and financial position so as to enable the responsible members of Ernst & Young to form an opinion and report within the terms of the statutory and regulatory requirements binding on them. However, it would not necessarily inform Ministers of the application of the accumulated knowledge and understanding of audit team members in forming such opinion. In any event one would risk exceeding the scope of the remit if one pursued the topic of the discharge of the firm's duties.

2. The audit material has been of value in providing support for evidence available from other sources. And it has identified certain matters of fact on which the auditors may have received less than full information about the Society's financial position. In addition to the documentary materials, I have obtained statements from a number of individuals associated with Ernst & Young, who were given an opportunity to comment on issues that arose from the analysis of the files. In common with other sources of oral evidence, the statements reflect collateral interests related to current litigation and possible professional disciplinary proceedings. I shall draw on them to the extent that I have been satisfied that they are both reliable and qualify or explain documentary records, or add information to that contained in the records on relevant issues. As I have sought to make clear generally, I do not regard this report as a platform for interested parties of any description to make self-justificatory observations related to issues that arise or may arise in other proceedings. It has been a common representation that I am inhibited from making adverse findings in relation to breach of duty. It might reasonably have been expected that I would be similarly inhibited from comment that might imply that any party had discharged its obligations.

Annuity Guarantees

3. It appears appropriate to deal first in this context, as I have generally, with the guarantee annuity issue.

4. Until the year ended 31 December 1993, the audit files did not contain material relating to the annuity guarantee issue, notwithstanding that guarantees and options were topics of general interest. Ernst & Young's audit programmes provided for discussion with the appointed actuary of a checklist of standard topics that included guarantees and options. Audit work reflected an interest in understanding how an insurance client's guarantees arose and how option terms included in contracts might be exercised. The appointed actuary was asked to explain how he brought guarantee liabilities into the mathematical reserves and technical provisions respectively. In relation to these issues, the auditor also had an interest in patterns of policyholder behaviour.

5. Ernst & Young's audit actuary, John Bannon, asked about guarantees in the course of an interview of Ranson early in 1994. Ranson told him that, as a result of a dip in interest rates, some policies with annuity guarantees had been in the money but that they did not present an issue. Ernst & Young retained sample contracts on the audit files. Having reviewed an example of a policy containing an annuity guarantee, auditors were aware in general terms of how the guarantee worked and of the schedules that showed how values built up over time. There is no reliable

evidence whether or not the differential terminal bonus policy was explained at that time.

6. An Ernst & Young actuary reported on discussions with Ranson during the 1994 audit. He was advised that a sustained period of negative fund performance could cause the guarantees contained in certain pension products to erode solvency and create problems for the Society. The point was not expanded on. It is apparent from the records that auditors had no knowledge that annuity guarantees were in the money prior to 1998, apart from the brief period over 1993/4. The Society did not make any provision in either the accounts or returns in this regard. In carrying out audit procedures, including the standard questions on guarantees and options, auditors were not advised of any potential risks or exposures in respect to annuity product guarantees.

7. The audit files for 1996 contained a paper prepared by Headdon and Nash that set out solvency projections for the period 1997 to 1999. The paper was reviewed by auditors. The issues revealed by this paper are dealt with below in relation to solvency. The scenarios discussed included one in which the Society sustained investment returns of negative 3%. The projections did not make provision for annuity guarantees.

8. The issue did not arise again until 1998. In November 1997 Bannon attended a Life Conference in Brighton. He was involved in discussions that reviewed approaches to managing annuity guarantees, including differential terminal bonus. The discussions related to the regulatory return process. But annuity guarantees were already an industry-wide issue at this time. Audit began inquiries relating to the Society's annuity guarantees in the summer of 1998. The initial response from the Society's actuaries was that they were currently reviewing their position but had not come to any firm conclusions. The first substantial discussions took place in November 1998, when Bannon met with Headdon to discuss the matter further. Headdon explained that the Society had been discussing its position with GAD. Bannon noted Headdon's position that, because of the differential terminal bonus policy, the take-up rate on annuity guarantees was very low, of the order of 1% or 2%, with the result that the actual cost to the Society was minimal. However, he told Bannon that the regulator was insisting on very onerous reserving, which was not consistent with actual experience. Later, he said that there had been discussions over Christmas and early in the New Year, when the regulator told the Society how the liabilities were to be valued.

9. The audit files reveal extensive investigation and discussion of the issues surrounding the accounting treatment of the annuity guarantees. Ernst & Young's risk assessment prepared at planning stage in respect of the 1998 audit identified relevant risks as: (a) that low long-term interest rates would trigger guaranteed annuity rates on with-profit pensions, giving rise to a strain on solvency where guarantee values were in excess of policies' asset shares; and (b) of adverse press publicity arising from the suggestion that affected policyholders might be entitled to the guaranteed rate and anticipated terminal bonus rather than one or the other but not both.

10. The audit strategies memorandum, also prepared at planning stage, noted that the guarantee involved a promise to pay a minimum annuity rate, but that few experts had thought the guarantee would ever have to be honoured. The recent decline in annuity rates, caused by the decline in long-term interest rates since the start of the 1990s and increases in longevity as life-expectancy tables were amended, had resulted in the guarantees having value. The memorandum also disclosed knowledge of the differential terminal bonus practice, and that it had generated much averse publicity for the Society.

11. A further audit planning document disclosed in greater detail the auditors' understanding of the history and issues relevant to annuity guarantees. The notes recorded:

"Prior to 1988 ELAS offered retirement annuities with options for guaranteed annuity rates. Interest rates are currently at historically low rates and consequently the guaranteed rates have become attractive to pension policyholders who are approaching retirement. The take up rate at present is approximately 2%. The guaranteed rate is only available if policyholders take all of their return as a level single life annuity that pays quarterly in advance, ie, they cannot commute part of their benefits - which many people like to do. In addition, at present, it is advantageous to take 25% commutation and use those funds to acquire a general annuity (annuitants are only taxed on the income element on general annuities).

The GAD has provided guidance to the industry on reserving for GAOs, which effectively requires that companies assume 100% (or something close to it) of policyholders take the option. 100% gross solvency. ELAS has negotiated financial reinsurance with ERC Frankona. ELAS will be able to recover amounts from ERC if more than 25%, by amount, of pension policyholders opt to take the GAO in a year. ELAS will be liable to repay ERC from future margins. It is not envisaged that cash will pass between ELAS and ERC.

Some ELAS policyholders believe that the GAO is in addition to the terminal bonus on the policies, whereas the Society's view is that, because terminal bonuses are discretionary, policyholders who choose the GAO will have their terminal bonuses reduced - potentially to zero. The Society's objective is, as far as possible, to make a policyholder's pay out equal to his/her asset share. The overriding objective being equity between members. An action group of disgruntled members has been organised by Stuart Bayliss of Annuity Direct. ELAS is financing a test-case in the High Court to establish whether the Society's stance is valid. The Directors have Counsel's opinion to support their view and are confident that they will be successful in Court. The £1bn exposure noted above assumes that ELAS will win the case.

The GAO issue poses a threat to the Society's solvency and capability to remain in business in its present form. Much depends on the movement in long-term interest rates and hence the attractiveness of the GAOs to policyholders."

At the planning stage, therefore, Ernst & Young had a considerable degree of understanding of the annuity guarantee issue, as presented by Equitable. It is not relevant for present purposes to discuss whether the views reflected in the documents were correct.

12. In the review of the regulatory return, auditors noted that the main issue to affect solvency in the year was the annuity guarantee provision of a gross liability of £1.6 billion, less reinsurance of just over £800m, resulting in a net reserve of under £800m. The audit summary review memorandum contained findings relating to the reinsurance contract arranged with Irish European Reinsurance Company Limited (referred to as ERC above) to cover potential guaranteed annuity liabilities. It was noted that:

"The reinsurer provides surplus cover for the costs arising from the exercise of the guarantee annuity rates in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before July 1988. If in any calendar year the proportion of terminations due to retirements exercising the guarantee annuity option exceeds 25% of the total retirements in that calendar year, as measured by the guaranteed funds for those polices, the reinsured gross liability is the value of the guaranteed annuity excess of the guaranteed policy funds for that portion of retirements effecting the guaranteed annuity option which is in excess of 25%."

The note reflected auditors' understanding that the arrangements had no practical financial effect at 31 December 1998, but that, in the event of a claim, the reinsurance would become a financing arrangement.

13. In considering the appropriate level of accounting provision, auditors had available a paper provided by Headdon which set out a number of possible views using different calculations based on varying assumptions. This showed that:

i. £50m was the anticipated realistic economic cost of the annuity guarantees;

ii. £350m was brought out using the same method as in the return, but with a lower take-up rate. There were other related numbers on a range of take-up rates; and

iii. The Society supported £200m by projections showing that the economic cost would be below that sum using an office model.

Ernst & Young ran the figures through one of their own computer models and although there was a slight discrepancy, it was not significant and they came up with a number that supported £200m. This equated to a take-up rate of approximately 10%, which was considered reasonable given the Society's experience.

14. In the audit closing meeting between auditors and the Society's executives there was wide-ranging and searching discussion of the provision to be made for annuity guarantees in the accounts. The proposal to value the liability at £200m had not been discussed with the audit committee at that stage, and the discussions covered anticipated problems in satisfying the committee of the validity of the provision of £200m.

15. Ernst & Young prepared a summary review memorandum dated 4 May 1999. Much of the material was repetitive of earlier notes. However, it disclosed in summary the nature and the extent of the information that was available on investigation, but that had not figured in earlier years' audits. And it disclosed the background to the decisions that were required and were taken in respect of the statutory accounts. The conclusions in the summary supported the approach adopted in the returns, and the provision of £200m in the accounts.

16. Audit formed the view that the 'true and fair' requirement would not be met by adopting the same value in the accounts for the annuity guarantees as was included in the returns, because:

i. The actual take up rate at the time was 1-2%, and the cost was minimal, well below that assumed in the returns, which produced a reserve of £1.6 or £1.8 billion;

ii. Due to the Society's differential terminal bonus policy, the actual annuity guarantee cost would be well below that provided for on the returns basis; and

iii. At that time the Society's management were very confident that what they were doing was right and in accordance with their powers.

The summary took comfort from the opinions the Society had obtained from counsel, which were reviewed. In addition to these considerations, the audit team consulted their in-house technical department, who confirmed that it would be appropriate for the amounts in the returns and the accounts to differ with a view to meeting the true and fair requirement in the accounts.

17. In relation to reinsurance, auditors noted that it was on the suggestion of the regulator that the Society sought reinsurance so as to reduce the exposure to annuity guarantees. Additionally the net amount required in the returns would be reduced. Auditors confirmed that they had a working knowledge and basic understanding of the reassurance agreement. They noted that:

i. The ERC agreement would take effect if the take-up rate were more than 25% in one year;

ii. The actual take-up rate was approximately 1-2% and so the reinsurance agreement did not impact on the accounts, as the amount provided for was based on an assumed take-up rate of well below 25%; and

iii. As far as the returns were concerned, the reinsurance did have an impact, because the returns assumed a take up rate exceeding 25%.

18. Auditors did not regard the reinsurance arrangement as being a typical or standard reinsurance agreement, but they had observed a similarly structured agreement elsewhere. It was understood that the agreement was a new type of reinsurance product and not a traditional one. However other reinsurers, in addition to ERC, wrote similar agreements. It was noted that the SORP set out how reinsurance should be dealt with in the accounts, and the treatment differed from that required in the returns.

19. When Ernst & Young signed off on the 1998 Companies Act accounts, the Society had already launched the court case. The auditors had been informed that the Society had sought legal advice on its position, had been reassured that the Society's position was correct and that it was funding the test case to stop future complaints with respect to this matter. When the auditors signed the accounts, it was considered that there was ample support for the view that the Society was entitled to use the differential terminal bonus policy. Accordingly audit considered there to be no contingent liability requiring disclosure in the accounts.

20. In the following year, 1999, Ernst & Young again highlighted guaranteed annuity options as a key area of focus. It was noted that the statutory reserve required for annuity guarantees had weakened the Society's solvency position. Some of the options available to strengthen that position had already been used, for example financial reassurance. Whilst the financial condition, as projected, appeared to be improving across a range of scenarios, it was noted that there remained a public concern over the Society's ability to cope with severe adverse experience.

21. Ernst & Young reported their audit plan to the audit committee. In respect to annuity guarantees the points noted were:

i. The Vice-Chancellor had ruled in the Society's favour on 9 September 1999, but had granted Hyman leave to appeal;

ii. Whilst the representative action continued, there remained some uncertainty regarding the potential outcome. But the first instance decision provided considerable support for the Society's approach;

iii. In the 1998 annual report, the amount provided in relation to the cost of options was £200m;

iv. The directors would need to reconsider the level of provisions and associated disclosures in the 1999 annual report and the return following developments in the year;

v. This area had been of particular interest to the press and had increased speculation over the Society's ability to continue as a mutual. Audit understood that the Society had conducted a review to assess whether other products could give rise to similar adverse coverage and solvency issues;

vi. Audit would review the approach taken to reserving for annuity guarantee options and would discuss this issue with management including the appointed actuary prior to the year-end; and

vii. Audit would review and discuss with management the outcome of the product range review and any disclosures and provisions that might be necessary.

22. The expectations were summarised as follows:

"In last year's financial statements ELAS provided £200m for GAOs liabilities in order to show a true & fair view of the Society's position. This provision may not be utilised if ELAS can continue to pay for GAO take-up by reducing the associated final bonus and bond yields remain above 3%. The liabilities for GAO policies extend to 2033 so there is considerable range for variation in the valuation of those liabilities.

In the 1998 HMT return ELAS provided £800m for GAO liabilities in accordance with GAD reserving guidance (ie not true & fair). This assumes that options will be taken up on 25% of policies and takes advantage of a reinsurance contract that caps the liabilities of GAOs (non-group) to 25% take up.

The actual take up rate is currently under 2%. This is due to the fact that notwithstanding the question of guarantees the annuities offered are not index linked and are single life and as such are not that attractive.

If bond rates fall to 3% then it is likely that the final bonuses would not cover the cost of the guaranteed annuities. Management has considered the possibility of purchasing a structured financial instrument to eliminate this risk but decided that this was too expensive given the current outlook for future interest rates.

We have yet to examine ELAS's proposed reserves for 1999 but it seems likely that given the absence of finality in the courts the current reserves will be maintained. Given that short-term interest rates have risen during the year while long term rates are largely unchanged then these reserves would continue to appear to be adequate."

23. Thereafter, the audit file recorded that the Court of Appeal judgment, in Ernst & Young's view, came as a surprise to everyone, particularly in light of the strength of the Vice Chancellor's opinion at first instance. However, the decision required a review of the audit approach. The conclusions recorded were that:

"Since issuing our planning report the decision of the Appeal Court has been announced and we are aware of preparations being made for the House of Lords' hearing. Until the House of Lords' decision is known, probably not until late summer, a significant degree of uncertainty still exists in relation to this issue.

The 1998 accounts contained a provision of £200m within the actuarial valuation as a realistically prudent view of the potential future cost of GAO's.

Employing more severe assumptions (as required for the FSA return) the suggested provision increases to £560m (1998 £800m). This assumes that options will be taken up on 25% of policies and takes advantage of a reinsurance contract that caps the liabilities of GAOs (non-group) to 25% take up.

In preparing the accounts, management have used realistic estimates of the cost rather than adopting a "worst case" scenario or one based on experience to date. The actual take up rate in 1999 has been less than 2%. This can be ascribed to the fact that the guaranteed annuities offered are not index linked and are single life only. A contributory factor to this low rate however may have been policyholders deferring decisions pending the outcome of the court case.

We have examined the Society's calculations of required reserves for 1999 using "realistically prudent" assumptions. These suggest a provision of £174m (1998: £179m). The reserve established in 1998 of £200m has therefore been retained. This reflects the continuing uncertainty in regard to the final court decision.

If long-term bond rates fall to 3% then it is likely that terminal bonuses will not cover the cost of the guaranteed annuities. Management have considered the possibility of purchasing a structured financial instrument to eliminate this risk but have decided that this is too expensive given the current outlook for future long-term interest rates.

We are aware that management have, with legal counsel, explored a number of strategies, which could be adopted in the event of an adverse Lords' decision. Since these proposals do not result in payouts in excess of asset shares we believe that the maintenance of the existing provision is a reasonable approach at this time."

24. Auditors also noted changes in the approach adopted by the Society since the previous year:

a. the interest rate assumption had increased by 0.25% to 4.25%;

b. the assumption that GAOs would be exercised if the income achieved was at least 5% higher than under the open market option had been removed;

c. the assumption that 25% would be commuted to cash had been removed. This and the previous change were consistent with the contingency plan following the court of appeal decision;

d. the mortality basis had been strengthened by an additional -1 age rating. This strengthening increased to -2 for older males;

e. the male retirement annuity pension age had been increased from 60 to 65 in line with experience;

f. the following table showed a breakdown of the GAO reserves:

(£m)	31.12.1998	31.12.1999
Retirement Annuities	88	57
IPAs	30	37
Transfer Plans	1	1
Group Pensions	60	79
Total	179	174

25. The auditors' position on the appropriate level of provision for 1999 was based on three factors:

i. The Court of Appeal did not exclude ring-fencing the annuity guarantee policies;

ii. The Society believed that, whether or not the Court of Appeal's judgment was reversed in the House of Lords, they could still use a compromise scheme to put them back in the same position as if they had the differential terminal bonus policy – the same position as in the Vice Chancellor's judgement effectively; and

iii. Their lawyers were comfortable it would work.

Hence the auditors considered that there was still no need for a contingent liability because the £200m provision continued properly to provide for the liability. Additionally Ernst & Young noted that it was for the Society to decide whether to disclose a contingent liability, and for them to form an audit opinion thereon.

26. Audit included in the conclusions with respect to statutory solvency:

"The statutory reserve required for GAOs and Pension Transfers has weakened the Society's solvency position. Some of the options available to ELAS in strengthening that position have already been used e.g. financial reassurance. Whilst the financial condition, as projected, appears to be improving across a

range of scenarios, there remains a public concern over the Society's ability to cope with severe adverse experience.

The Society has entered into a reinsurance policy, which mitigates the extreme impact of the GAD's requirements in regard to the FSA Return."

27. In planning for the audit of the 2000 accounts, the key areas of focus inevitably included the impact of the House of Lords' decision on provisioning for the cost of the annuity guarantees. In reporting to the audit committee on the audit plan, Ernst & Young also identified investment performance and fundamental breach of regulations as key business risks for consideration by them during their work.

28. The auditors commented in addition on the understanding that, as a result of the House of Lords' decision, the Society did not believe that it was financially strong enough to continue in its present form and had therefore had to put itself up for sale. Furthermore they identified the severe deterioration in the Society's financial condition as a significant risk item, and noted that public criticism and litigation with respect to the Society's business practices were issues. The auditors also acknowledged that there was a reasonable possibility that their appointment could be terminated.

29. At planning stage, in reviewing the impact of the annuity guarantees on the Society's solvency, Ernst & Young commented:

"ELAS's historic stance on reserving for these GAOs has been that all policyholders would receive their notional asset share. This effectively meant that the cost of the GAO was funded by reducing the terminal bonus on those policies where the option was exercised.

During 1999 the House of Lords ruled that ELAS would have to pay the GAO in addition to the terminal bonus on the relevant policies. This effectively increased ELAS's technical liabilities by an estimated £1.5bn. On current estimates by the Appointed Actuary (discussed at January audit committee meeting) the Society remains solvent after this increase in liabilities but is unable to fund the new business strain and maintain a commercial bonus rate. As a result the Society has put itself up for sale and subsequently closed to new business."

30. In relation to provisions in the accounts, notes at planning stage included observations that:

i. As a result of the House of Lords' ruling, the provision for the cost of annuity guarantees would need to be increased significantly from the £200m included in the 1999 accounts;

ii. Various estimates of the actual cost had been made in the press and estimates differed greatly, depending on the assumptions used;

iii. The Financial Reporting Review Panel (FRRP) had been asked by two policyholders to review the disclosure and audit of this provision in the 1999 accounts, but had yet to respond to those requests;

iv. Following the settlement of the appeal the directors would need to reconsider the level and disclosure of the provision required in both the accounts and the FSA return;

v. Decisions regarding the impact of future premiums to existing GAR policies required to be agreed and communicated by the directors;

vi. If the House of Lords' decision could be classified as a change in law the increase in the provision could be dealt with as a prior year adjustment;

vii. If the FRRP ruled that the 1999 accounts were deficient, they might insist on these accounts being corrected and reissued;

viii. Ernst & Young would review the approach taken to reserving for annuity guarantees in 2000 and were already discussing this issue with management including the appointed actuary;

ix. Legal opinion was being sought in relation to whether the decision constituted a change in law; and

x. Ernst & Young were working with management to prepare a response to the FRRP and believed there were strong grounds for insisting that the 1999 annuity guarantee provision was reasonable, based on information available at the time the accounts were approved.

31. In reporting to the audit committee on the audit results, Ernst & Young made a number of comments on the provision for guaranteed annuity rate options. They rehearsed the 1999 position, drawing attention to note 17 to the accounts, and commented on the need to make changes in 2000. They said:

> "The disclosure made in 1999 (and 1998) was entirely voluntary and we are not aware of any other life company which made specific disclosure of its GAR liability in the Companies Act accounts. The historic purpose of disclosure was to give information that was comparable to the disclosures made in respect of pension transfers and opt-out liabilities <u>and</u> to indicate that notwithstanding the suggestion that the Society was reneging on its obligations there was a real cost arising and benefit to certain policyholders where the application of the GAR to the sum assured and reversionary bonuses gave a policy value which exceeded the cash fund including terminal bonus.
>
> The 1999 provision was made based on the expected cost arising as a consequence of the Court of Appeal judgement. There have been a number of adverse comments by policyholders regarding the quantum of the amount provided and the wording adopted. Their suggestion being, in substance, that the last year's accounts should have included a provision that was on a 'worst case' basis comparable to the findings of the House of Lords or a contingent liability disclosure indicating the potential cost of a judgement which was more adverse than had been adopted by the Court of Appeal.
>
> The Financial Reporting and Review Panel has not instigated a formal enquiry but issued three letters asking for information relating to the 1999 accounts disclosure and more specifically made enquiries about the wording adopted in Note 17 and the adequacy of disclosure of the contingent liabilities that would crystallise if the House of Lords arrived at a judgement more adverse than the Court of Appeal."

32. They reported that, as a result of the House of Lords' decision, the provision for the cost of GARs had to be increased significantly from the £200m included in the 1999 accounts. The Society in conjunction with its actuarial advisers had modelled several different scenarios, having made critical assumptions about:

- future long term interest rates;
- future mortality;
- the propensity of GAR policyholders to purchase in whole, or in part, a single life level annuity with their cash fund at the guaranteed rate; and
- the level of future contributions to be made by the GAR policyholders.

In addition, they noted that approximately 27,000 individual GAR policyholders and a similar number of group scheme members with GARs had exercised their annuity rights on the basis being offered by the Society prior to the House of Lords' decision. As a consequence it was now necessary to review the offers made to each policyholder and offer rectification if they would have chosen a GAR annuity, had they been offered it on the basis of the House of Lords' decision. The report commented that the basis of preparation of the 2000 accounts made no assumption

about the potential beneficial consequences of the Halifax contract. In particular, no assumption had been made about the likelihood of success in capping the GAR liability. Technical provisions had not been reduced to reflect the proposed change in contractual obligations under the GARs, whereby the guarantee was to be replaced by an increase in the terminal (or reversionary) bonus attributable to GAR policyholders.

33. On the basis of these points, it was reported that in the Companies Act accounts a provision of £1.8 billion had been established. The effect had been to put a charge through the technical account of £1.6 billion to increase the total technical provisions to £31.4 billion with a consequential reduction in the fund for future appropriations. The charge for the year, including an additional £200m in respect of the rectification scheme, had been specifically shown on the face of the profit and loss account. Ernst & Young reported that, in arriving at the provision made, the assumptions about mortality and interest rates were consistent with those made for other parts of the actuarial valuation and were consistent with the disclosures made in note 18 to the accounts. They commented on take-up rate experience. Since the House of Lords' decision, the rate had been relatively consistent, indicating that a take up-rate of 55% might be appropriate although the take-up rate in December was 57%. However there was uncertainty as to whether the experience of recent months was representative of policyholder behaviour in the future and accordingly the provision had been set on the assumption of a 60% take up rate. The change to 60% had increased the charge by £300m. Management would review the January take-up rate, once it had been calculated, as a further indication of likely policyholder behaviour. If it indicated experience in excess of 60% the basis of the provision would require reconsideration.

34. It was also reported that the population of GAR policyholders was a discrete and reducing group. There were approximately 215,000 such policyholders at 31 December 2000 of which the majority were not making additional contributions, indicating that they no longer had the net relevant earnings eligible for contributions. The assumption was that with the declining population eligible to make contributions, future contributions would fall by 5% per year. This assumption was previously 20%. If policyholders had restored confidence about future investment performance, contributions could increase but the generally negative publicity was more likely to lead to a fall in future contributions. The rate of decline in policyholders was approximately 6% p.a., but those remaining typically made greater contributions, so the assumptions made some allowance for increased contributions.

35. The actuarial estimate for the rectification scheme was approximately £200 million, which was in addition to in the £1.6 billion charge above. Ernst & Young expressed the view that it was not necessary under FRS 12 to note as a contingent liability the inherent uncertainty in the insurance technical provisions that arose from the judgments that had to be made in arriving at the provision.

36. Revised footnotes had been drafted that indicated the level of the provision and referred to the issues in respect of which assumptions had to be made. There was no specific disclosure about take-up rates or future contribution rates. The draft wording recognised the uncertainty relating to take-up rate and future contributions for which there was limited historical experience. In view of the potential impact on the fund for future appropriations, the draft referred to a fundamental uncertainty that had been reflected in an additional paragraph in the audit report. This form of audit opinion was covered by auditing standard AS 600 which stated:

> "Where resolution of an inherent uncertainty could affect the view given by the financial statements to the degree that the auditors conclude that it is to be regarded as fundamental, they include an explanatory paragraph when setting out the basis of their opinion describing the matter giving rise to the fundamental uncertainty and its possible effects on the financial statements."

Determination and Allocation of Surplus 1990 - 2000

37. Ernst & Young's audit files did not disclose notes of review of the Society's analysis of surplus. Audit, in the firm's view, had no role to play in the determination and allocation of surplus. Those were entirely matters for the Society's Board and management to consider and resolve, on the advice of the appointed actuary. The firm regarded the appointed actuary as solely responsible for determining the amount of surplus available for distribution. That view was shared by the appointed actuary who would have taken exception to any one in an audit role interfering.

38. Furthermore the Companies Act accounts did not show surplus. Surplus was disclosed in the regulatory return alone. The extent of audit involvement in this area was limited to discussion with the appointed actuary in order to gain the understanding of the various bonus considerations that audit required in order to understand the liability valuation generally. There was a particular need for understanding because the Society performed its liability valuation on the bonus reserve basis (gross premium method).

39. However, the analysis of surplus, which the client prepared to set out the factors that had given rise to the year's actuarially determined surplus, was an internal matter for management. Review of the analysis was not deemed necessary for the purposes of Ernst & Young expressing a view on the accounts.

40. Additionally, the Society only produced an analysis of surplus some months after the publication of the accounts, and consequently it was not available for review prior to audit signing off the accounts. Ernst & Young did not seek to perform a retrospective review of the prior year's analysis of surplus. If such analysis had been available on time then they would have looked at it. Analysis of surplus was considered by Ernst & Young to be a useful and necessary management tool and would have been looked at in that light. For unit-linked business in particular, an analysis of surplus was a powerful tool. Ernst & Young considered it to have less value in relation to with-profit business. The extent of audit work performed in this general context would have centred around the in-house actuaries' review and assessment of the reasonableness of the valuation assumptions used.

41. The audit files did contain references to bonus. These are noted in the next section.

Liability Valuation

42. Ernst & Young's approach to the recognition of liabilities in the context of audit was that audit was concerned with contractual or guaranteed liabilities. Since terminal bonus was not guaranteed, and that was the position stated in the Society's bonus notices, it was not regarded as constituting a liability for Companies Act accounts purposes. They regarded terminal bonus as declared at the point of vesting and not earlier. Accordingly Ernst & Young held the view that there was no justification for requesting the Society to accrue for terminal bonus allocations. Essentially Ernst & Young considered that the terminal bonus mechanism gave the policyholder an indicative value of what their policy might yield in the future, subject to market conditions.

43. Past practice of paying out terminal bonus might result in the policyholder having high expectations of receiving terminal bonus, but these values were un-guaranteed and would possibly not be paid out in every instance. On this basis Ernst & Young held the view that there was no justification to accrue for terminal bonus either, as no legal or constructive obligation existed to pay them. Accruing for one year's terminal bonus would not inform policyholders, and would simply result in a shift within the balance sheet. Ernst & Young were aware that some insurance companies had accrued for up to three years' terminal bonus to demonstrate a greater degree of prudence. But these companies were in the minority, and the practice was unusual in the industry.

44. In the course of work on the 1990 accounts, audit reviewed Board papers and minutes. Audit noted that Ranson had stated to the Board:

> "The board will recall that the approach being taken to the valuation is rather different this year than in recent years. In summary, the basis for valuing the liabilities is being weakened to reflect the higher yields available on assets as at 1 December 1990. The effect of that weakening will enable bonuses to be declared at 31 December 1989 levels without any transfer from the investment reserve in the Companies Act Accounts."

Whilst at planning stage, audit had identified that the Society had weakened the liability valuation bases so as to maintain bonus rates in line with those declared in the prior year, and with competitors' rates, in addition to avoiding solvency problems. Audit noted that it had been stated by management that, provided market conditions permitted, the Society would revert back to the old method in the following year. Audit indicated an intention to monitor the situation to ensure that the valuation basis returned to 1989 levels. The audit records also stated that the change in valuation was directly linked to the Society's poor investment returns.

45. In 1990, the Society adopted a valuation method different from that applied previously, which directly impacted on their year-end accounts. The effect of the change was to generate distributable surplus without transfer of credit between the investment reserve (balance sheet) and the long-term revenue account (income statement). In ordinary course this transfer had provided for the recognition of capital appreciation as distributable surplus. In previous years the transfer was from the balance sheet to the income statement and reflected the extent of the Society's dependence on capital appreciation to augment distributable surplus, but also demonstrated that the required capital appreciation was available.

46. Audit acknowledged that this change in practice was largely attributable to economic events of the year with a comparison being drawn to the similar situation experienced by the Society in 1974 when there were negative investment returns. Audit suggested that this change was also attributable to market competition, and reflected the Society's desire to avoid appearing weak. The auditors considered that the change of method was a departure from the Society's "normal prudent approach".

47. This departure from normal practice in the preparing the accounts was considered by audit to be motivated by the Society's need to avoid "adverse publicity". It was noted that in form 40 of the regulatory return "a transfer to reserves of £214m had been made, corresponding to a transfer carried out on the appropriate old basis". In the previous year the comparative 1989 figure had been a transfer from reserves of £317m. The latter basis of presentation agreed with the treatment in the 1989 Accounts. Audit concluded that the form 40 gave a "truer reflection" of events, but they considered there was no basis for "challenging this form of presentation", though it represented both a departure from prior year practice and a difference in presentation between the accounts and regulatory returns.

48. Audit raised with Headdon the need to include in the liability valuation two additional reserves; a closure reserve, and a mismatch reserve. It was noted that Headdon indicated that no such reserves would be provided for; because a closure reserve was only needed where the loadings in premiums were inadequate to meet 'run-off' costs, and mismatching would be catered for in the margin between the net premium and bonus reserve (gross) valuation methods. No notes of audit's vouching of the reasoning or validity of Headdon's points were found. Audit also noted that all contingency reserves, previously held in the liability valuation, were written back in current year.

49. The change of valuation approach released surplus. Audit recorded the significant influence of market competition on the Society's bonus rate decisions for the year. It was noted that the Society had considered not declaring a bonus in the

current year, but had decided against that course due to the potential market impact. The declared bonus rate for 1990 was held at the same level as that declared in 1989.

50. The total bonus allocation for the year resulted in aggregate policy values exceeding the value of the Society's assets at market value. Audit noted and queried management's decision to depart from the previous practice of presenting to the Board an assessment of the 'asset share' position of the Society. Management's response was noted to have been that, due to the poor investment returns of 1990, less emphasis was being placed on the asset share approach. It was not evident from the inquiry's review of the audit files whether audit knew the Society's actual asset share position at year-end or the extent of possible over-allocation made in respect of the year.

51. In the course of the 1991 audit, Ernst & Young again reviewed Board papers and minutes. Documents dated October 1991 revealed that the weak liability valuation remained a topic of discussion for the Board in 1991. The auditors recorded that, in a meeting with them, the appointed actuary had acknowledged the weakening of the liability valuation basis in 1990 through the increase in assumed interest rates. The appointed actuary had, in relation to 1990, indicated to audit that, provided investment performance permitted in 1991, he intended to return back to the stronger interest rate basis of 1989. If this was not possible, then he had stated that both the overall bonus allotment and reversionary bonuses would need to be cut.

52. In notes of a subsequent meeting with audit, it was recorded that the appointed actuary explained the difficulty in reducing the overall bonus allotment (overall roll-up rate) in 1991, "given the reasonable investment performance in the year, when the 1990 rate was maintained despite a very poor investment performance". It was further emphasised that the Society intended to play down the significance of the guaranteed bonus element in bonus literature, since these rates were likely to fall further in subsequent years. The audit partner, Richard Coombes, enquired how final bonuses were provided for. The appointed actuary narrated a technical discounted cash flow explanation. Audit's views on this issue were not recorded.

53. The planning section of the audit file for the 1992 audit contained commentary of audit's views with regard to the year-on-year movements in the actuarial bases. The comments recorded were as follows:

> "Due to poor investment performance in 1990 ELAS was forced to increase the discount rate for its liabilities in order to maintain bonus rates.
>
> A yield of around 15% was required in 1991 to enable the bonus rates to be maintained without weakening the solvency position.
>
> In the event a yield of only 13.5% was achieved and the client did not return the valuation to its pre 1990 value but instead originally reduced the discount rate on new money in 1991 but used the same discount rate as for 1990 on premiums received before 1991.
>
> This had the effect of slightly strengthening the valuation on the 1990 basis by some £150m. However this leads to a weak Form 9 position and in view of the significance placed on the strength shown in this form by various analysts it was later decided to reduce the strength of the valuation with all policies being valued on the 1990 basis except for bonds, which were valued on a stronger basis.
>
> The final valuation was some £10m in excess of what it would have been based on the 1990 basis. The final valuation was significantly stronger than the statutory minimum basis and no problems with the DTI are anticipated...

We must carefully review the steps taken in 1992 to strengthen reserves and ensure that managements concerns in remaining competitive do not result in the further weakening of the fund."

54. During the 1992 audit review of Board papers and minutes, it was noted that, in a paper prepared by Ranson and presented to the Board, the actuary had commented on the following issues:

i. Ranson had reminded the Board of his intention to strengthen the 1992 liability valuation, as intimated during the previous year when he presented the 1991 liability valuation.

ii. He indicated that he had reconsidered matters and felt that he had further room to move within the current regulations.

iii. Accordingly the 1992 valuation was a "little weaker than advised earlier in the year", which effectively meant that some of what would have been held in the liability was being shown in 'free assets,' where Ranson felt they were still essentially being reserved for.

55. Audit also reviewed the paper 'Valuation and Bonus Declaration' prepared by Ranson, which showed, inter alia:

i. Ranson indicated that when considering the declared bonus rate there were certain public relation aspects to be borne in mind, but what was of importance was the overall rollup rate (total allotment) for the year.

ii. Ranson highlighted in his comments to the Board that the excess over the declared bonus rate was not guaranteed and therefore did not have to be reserved for.

iii. Ranson recommended that in light of an earned return of 18%, a 10% allotment might be a little too low but he reminded the Board of the need to recoup the over-distribution of 1990.

56. The audit file contained a copy of an insurance technical update, prepared by Tillinghast, which set out the consultants' views on PRE and terminal bonus, and noted:

"Actuaries will, however, need to apply their view of (policyholders') reasonable expectations in assessing the adequacy of the long term liabilities. This raises many questions as to the level of reserves which should be held. For example, if policyholders expect terminal bonuses, should the actuary reserve for accrued terminal bonuses, or is it sufficient to ensure that the investment reserve is sufficient to cover this liability?

How should the actuary act if the investment reserve is not sufficient to cover accrued terminal bonuses at current rates? There will need to be considerable discussion between the appointed actuary and the company's board in this difficult and ill-defined area."

The file does not disclose whether the discussion paper prompted any consideration or action by audit on the issues presented.

57. Over a series of discussions between audit and the Society's management regarding the valuation bases, Headdon indicated that the Society might not return to its 1989 basis, which was considered strong in comparison to the market, as this strength gave a weak form 9 position and had attracted attention from brokers. In a meeting with audit, including Ernst & Young's actuarial support team member, Roger Laker, Ranson indicated that he was happy with the strength of the valuation but was reconsidering the balance between keeping the liability valuation strong and having a weak free asset ratio. Ranson's views on this were thought to imply that to show significant free assets while having a weak valuation basis was an effective PR stunt.

58. Audit noted that questions had again been asked of management about asset shares:

i. Why there was no commentary in Board papers on asset shares?

ii. Would proposed bonus rates bring payouts in line with asset share?

iii. If not, were the levels of expected maturities going to be significantly higher in the next few years, indicating potential solvency problems?

59. Headdon's replies were noted as follows:

i. More emphasis was being placed on investment return than on asset share.

ii. Policy values were higher than asset shares in 1990 (120%) but were coming back in line and it was likely to take 2-3 years to correct, failing any dramatic changes to the markets.

iii. The ratio of policy values to underlying fund asset was 118% in 1991 reducing to 113% in 1992.

60. The planning section of the audit file for 1993 set out the part Ernst & Young's actuarial audit team would play in the overall audit process. The notes described the position as covering:

i. reviewing the assumptions underlying the reserve calculations,

ii. reviewing the audit work performed to ensure no key areas were omitted,

iii. to ensure that the audit team were not over auditing, and

iv. discussing the valuation with the actuaries.

These procedures were considered sufficient to give audit overall comfort on the value of the reserves.

61. The file recorded the performance of these procedures. The notes and conclusions of the actuarial team on the regulatory return and more specifically the mathematical reserve were as follows:

i. Management indicated that a decision had been taken not to strengthen reserves further, due to the adverse publicity that the Society had received in the past regarding its form 9 free asset position;

ii. The actuarial audit work concurred with the Society's actuaries' opinion that the reserve figure was prepared on a prudent basis. The actuarial partner, Roger Laker, expressed this view.

iii. In a pre-audit committee meeting, it was observed by the members that the Board and the auditors placed reliance on a combination of the appointed actuary's valuation and the external checks performed by the regulator.

62. Audit recorded the Society's approach to setting bonus mix from a review of the board papers:

> "The next stage is to determine how the overall roll-up rate for the year should be split between declared and final bonus ie between guaranteed and non-guaranteed allocation. As the board will recall, our established approach is broadly to relate the level of earnings passed on by means of declared rates to the prevailing level of fixed interest yields. From a high point in the mid 80's we have implemented a steady program of reducing rate so that we have reached a rate of 5% for our main classes of business which corresponds to a return of 8.7% [taking into account the basic accumulation rate of 3.5% guaranteed within the contract.]"

63. The auditors held a meeting with Headdon to discuss declared bonus rates. They noted that terminal bonus rates had been increasing as declared bonus rates

were decreasing. Headdon explained that this had an impact on investment decisions in that less was required to be invested in lower yielding gilts due to policy guarantees being lower.

64. The auditors met with Ranson. His comments on asset shares mismatch were noted as follows:

> "... there is a slight mismatch here between the asset shares of older business vs. that of newer business but this is not significant.
>
> ... JB enquired about ELAS's with-profits philosophy. RR indicated that ELAS did not have an estate as all earnings were passed on to policyholders and by holding on to some you actually do so to the detriment of some tranche of policyholders.
>
> ELAS try to smooth over a 3-5 year period but try not to get tied down too much here ie they try to keep this decision down to the discretion of the management.
>
> Terminal bonuses are reviewed on a regular basis but they have not been officially changed from the levels announced for some years."

65. It was noted that the factors considered in the calculation of the bonus level as included within the valuation and bonus declaration paper presented to the Board were:

i. declared rates;

ii. valuation results and relative strengths for 1993 vs.1992 and 1989 plus DTI form 9 effects;

iii. total policy values re growth rate to be declared, and the PR effect this would have on ELAS rankings with competitors.

66. In reviewing the board papers, audit identified the information provided to the Board by management that disclosed the asset share position of the Society at 31 December 1993. The Board were told that total policy values still exceeded underlying assets, with 1993 being regarded as the converse of 1990. It was indicated that an allocation of around 12% when "useable" earnings were around 17%, would restore the position of balance between assets and policy values. The review of an investment committee paper by audit revealed a statement by Ranson that current payouts were generally in excess of underlying assets.

67. At a pre-audit internal planning meeting relating to the 1994 audit, it was recorded that audit discussed the requirement of a 'true and fair' view audit opinion which would be come into effect when the Society adopted the insurance SORP early . The fundamental difference from past years was identified as audit's requirement to obtain a 'greater understanding' of the long-term business valuation. This initiated a review of audit procedures so as to identify where additional work would be required.

68. The audit-planning memorandum was modified in relation to the liability valuation. Additions were:

i. The single most subjective area was the valuation of future liabilities arising out of policies in force.

ii. This valuation was performed by the actuaries in terms of the rules of their professional society.

iii. Valuations in the industry generally were based on net premiums, while the Society used a gross premium valuation.

iv. This method included both terminal and reversionary bonuses.

v. The Society had been criticised for using too prudent a method of valuing the fund, but it was unlikely that they would change their methods.

In a planning meeting between audit and the Society, Headdon stated that he did not intend changing the valuation strength: rather that the presentation of the basis would change to comply with the new regulations.

69. However audit noted that when the formal paper on the valuation and bonus declaration was presented to the Board by Headdon and Nash on Ranson's behalf, it was stated that:

i. The overall return on the fund at market value in 1994 was minus 5%.

ii. The total value of liabilities was around £725m lower than would have been the case had the 1993 valuation basis continued to be appropriate.

In a meeting with audit, Ranson confirmed that the basis was the weakest permissible under the regulations. He maintained that the current valuation was marginally stronger than the previous year's. The reason given for this was that the new regulations required each assumption to contain a margin for adverse deviation, whilst the previous regulations only required the overall aggregate to be prudent. There is no note of an attempt to reconcile this statement with the apparently contradictory statement made by Headdon and Nash earlier to the Board regarding the weakness of the valuation.

70. Audit discussed the weakness of the liability valuation and concluded that they were satisfied, on the basis of the information provided to them, that the valuation was prudent and complied with the new regulations. This conclusion was reached after considering the following factors:

i. The Society used the weakest possible valuation basis, and it was considered that a regulatory mismatching reserve for resilience testing was not needed.

ii. Despite using this weak valuation bases, the Society still showed a weak free asset ratio of 3.4% compared to 11% in 1993.

iii. The Society would be further weakened if there was a sustained period of poor investment performance

71. No matters of significance were noted with respect to bonus. Audit discussed the Society's asset share position at the end of 1994 with Headdon. It was noted that:

i. Headdon had indicated that, at the end of 1993, policy payments were in line with asset shares (the position being about 101% before allowing for deferred acquisition costs but excluding profits from non-profit business).

ii. The position at the end of 1994 was about 10-12% adrift.

iii. Appropriate transfer and surrender penalties were being applied, but contractual claims and maturities were not adjusted to reflect the lower market values.

72. Audit noted that they had reached the following conclusions in response to their enquiry:

i. This matter should be reviewed at year-end, as it would appear that subject to the Society's smoothing policy, bonus rates would need to be cut.

ii. If market conditions persisted then year-end free assets would be in the area of £400m compared to the preceding year value of £1.4 billion.

In a further meeting between audit and the Society, Ranson confirmed that policy payouts were in excess of asset shares. The meeting's conclusion was that the sustainability of current bonus rates would very much depend on future investment returns and that the current overpayment of approximately 10% over asset share was clearly not a sustainable position.

73. In preparation for the 1995 audit, Ernst & Young carried out an internal review on the 1994 audit. In respect to the work carried out to support the 'true and fair' opinion given, it was recorded:

i. The actuaries on the audit team needed to address the additional audit risks faced by giving a 'true and fair' audit opinion.

ii. Concern was expressed over the apparent lack of challenge carried out by audit in respect of the valuation assumptions.

iii. The audit engagement partner, Richard Combes, countered this 'challenge' argument by stating that:

a. he considered the valuation to be based on reasonable assumptions;

b. the Society was a mutual (therefore any valuation mis-statement would only affect the balance between the technical provisions and the fund for future appropriations);

c. bonuses were based on 10-year (smoothing) cycles; and

d. one needed to accept that the valuation was performed on a prudent basis.

74. In a meeting between audit and Headdon the liability valuation was discussed. Headdon indicated that the interest rates used in the valuation were to be strengthened (by a reduction in rates) as yields were down. In concluding the report on the valuation audit work, audit requested the actuarial team to confirm that the bonus rates and assumptions were those discussed and agreed by them with Headdon.

75. The actuarial summary review memorandum for 1995 identified a disagreement on actuarial assumptions between audit and the Society. This matter was outlined as follows:

> "They use what I consider could be an under-prudent assumption with respect to future payments of recurrent single premiums.
>
> They assume, on a policy-by-policy basis, that the premiums continue to be paid at the average of the premiums paid over the three years prior to the valuation. As the recurrent single premiums include a loading for initial expense on the contract it would be more prudent to assume that no more premiums are paid.
>
> They have reviewed this and the effect would be to increase the (non unit) reserves to £19m from £16m ... if they took a worst-case scenario and they would rather not have to do this as they consider that it is not necessary.
>
> Although I am not happy with this, for the accounts the approach they are taking is not unreasonable and in fact is more realistic than the approach strictly allowable for the DTI returns. For the DTI returns I have expressed my concerns and it is up to the Appointed Actuary to decide. However, I do not think this issue would have a significant impact upon solvency."

76. The audit actuarial summary review memorandum noted communications between DTI and the Society with respect to the 1994 valuation bases used in the regulatory return. It was noted that DTI had queried the Society's general annuity mortality basis used in the valuation. The Society had responded that the basis used was in line with office experience but that, nonetheless, they would be strengthening it for the 1995 valuation. Subsequently in a later 'valuation' meeting between audit and Ranson and Headdon the use of new actuarial tables was discussed. The actuaries confirmed that in the 1995 valuation the new annuity tables would be adopted for annuities only, and that otherwise they would move across to new tables, possibly, later on in 1996.

77. The audit actuarial files included copies of correspondence between the Society and GAD. There were technical queries about asset valuations and mortality. Ranson had written to Chamberlain:

> "... I have to say that I find a somewhat similar flavour to your comments about the appropriate mortality bases to be used for annuity business. The GAD's right to seek confirmation that Appointed Actuaries have had due regard to relevant factors in determining their choice of basis is undisputable although, I would hope, generally felt to be unnecessary. Your comments appear to imply a rather different approach, whereby the GAD decides what is a professionally satisfactory choice of basis and then sees how close offices come to that. That carries the unfortunate impression that the GAD feel the only people capable of exercising true professional judgement are themselves."

78. Included in the Society's bonus declaration discussion paper prepared by Nash and Headdon, and noted by audit, there was consideration of the over-distributions for 1990 and 1994:

> "The negative actual return in 1994 has led to another period where allocated earnings have run ahead of the actual position. A natural reaction to a relatively high actual return for 1995 would be to allocate less than the actual earnings, so beginning the process of bringing actual and allocated returns back into line over the current smoothing period.
>
> Experience has normally been smoothed over periods of 3-5 years and that would indicate that the aim should be to eliminate the current margin of allocated over actual earnings over the next 2-3 years."

79. The audit file contained extracts from the Society's promotional literature entitled 'The Society's approach to transfers and switches from with-profits personal pension contracts'. It explained the effect of smoothing of profits against volatility of the market, the market value adjustment and mentions "underlying assets":

> "Up until 31 December 1993, the accumulated returns allocated were broadly in balance with the accumulated return earned over the various periods of time. During 1994, the Society earned about -4% on its assets but allocated 10% for the year. In other words, earnings for 1994 ran 14% behind allocations. To date in 1995 11% has been earned and policies have accumulated at about 7%, hence earnings have run 4% ahead of allocations. The basis currently used is therefore to deduct 10% of the 31 December 1994 value from the current claim value to reflect the shortfall of earnings in 1994 compensated in part by excess earnings in 1995 to date. This adjustment is therefore intended to bring the value on surrender or transfer broadly in line with the market value of the underlying assets."

80. Grenham of Ernst & Young held a meeting with Headdon, Loseby and Pielage to discuss the actuarial valuation. The file noted:

> "The with-profits business contains a guaranteed bonus rate of 3.5%. They are declaring a total of 4% (the same as for 1994). ELAS are reviewing whether they should remove the guarantee altogether. An MVA is applied on surrender, currently 10% of the value of the policy."

81. The files for the 1996 audit contained general discussion of valuation issues. The actuaries on the audit engagement team noted their view that, for DTI return purposes, the valuation was to be carried out in accordance with guidance notes GN1 and GN8 and the Insurance Companies Regulations 1994. It was noted that the guidance and regulations did not in terms apply to the mathematical reserves for statutory accounts purposes. But in the absence of any relevant guidance or legislation, it was considered appropriate to use the guidance notes and regulations as a basis for developing assumptions for actuarial items appearing in the accounts (particularly as nearly all offices used DTI mathematical reserves, modified as appropriate, in their accounts). Additionally, it was noted that policyholders were

likely to have different objectives from shareholders. Therefore the appointed actuary was required to take PRE into account in carrying out his valuation.

82. The client service memorandum set out audit's observations on Ernst & Young's responsibility with regard to the audit of the Society's long-term business fund as they understood it at that time:

> "As stated in the accounting policies the Appointed Actuary determines the long-term business provision. Consequently, we aim to achieve the following objectives in relation to the amount of the long-term business fund and any distribution of surplus during the year:
>
> a. to obtain a reasonable assurance that the assets of the long term fund are not less than the related liabilities;
>
> b. if a surplus in any fund has been ascertained, to establish whether this amount has been materially affected by a change in the valuation approach or assumptions or by exceptional circumstances that may require disclosure in the financial statements; and
>
> c. to satisfy ourselves that any distribution of surplus made by the insurer complies with sections 29 and 30 of the Insurance Companies Act 1982 and with the Articles of Association."[1]

83. Audit noted that fund weakness and a low free asset ratio might place pressure on the assumptions used in the liability valuation. This risk would need to be monitored throughout the audit process.

84. Planning for the audit of the 1997 accounts involved review of a paper by Clive Letchford dated 7 April 1997 entitled 'Preparation of accounts for a life office'. The following are extracts from this paper:

> "Prior to the new Schedule 9A, accounts had not had to show a true and fair view; in particular, the very prudent approach of the DTI return was followed in the statutory accounts as well. There was no concern that the amounts set aside as reserves were excessive from an accountant's perspective and that the accounts consequently contained hidden reserves.
>
> The basis on which accounts are prepared is frequently known as the Modified Statutory Solvency Basis or 'MSSB.' This is because it uses the figures in the DTI return as its starting point in that the reported profit is based on Actuary's transfer from the long term fund; probably the major difference is that all assets are admissible."

Audit planning identified the valuation liability as a significant amount. The records do not disclose whether an assessment of inherent risk or control risk was performed.

85. Audit prepared a valuation summary review memorandum. This document was by this date usually prepared by Ernst & Young actuaries and solely reviewed the valuation liability. For 1997 it did not disclose consideration of any of the following:

i. asset shares;

ii. policyholders' reasonable expectations;

iii. guaranteed annuity rates; or

iv. movement in embedded values during the period.

The audit valuation summary review memorandum stated that it had been necessary to hold a resilience test reserve at 31 December 1997. Audit actuaries had reviewed the calculation of that reserve and were satisfied that it was calculated using appropriate methodology.

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[1] These objectives repeated substantially the terms of paragraph 79 of AG 311.

86. In planning for the year-end audit, a meeting was held between Headdon, Bannon and Combes. The actuarial valuation basis was discussed:

> "Chris Headdon intends using a stronger valuation basis this year reflecting the removal of the ACT credit. The valuation basis will, for the first time in six or seven years, be stronger than the premium basis. This means that there will be an immediate valuation strain (ie initial actuarial reserves will, all other things being equal, be higher than the recurring single premiums received and the difference will run off over the lifetime of the policy. Chris is looking again at the annuitant mortality. A new table was introduced last year but Chris wants to review the extent to which improvements in mortality are allowed for."

87. During the actuarial closing meeting Headdon commented to Coombes and Bannon about the resilience reserve:

> "For the first time an explicit resilience reserve has been shown. Chris hopes that in future he will be able to maintain a steady valuation basis and vary the explicit resilience reserve as required. He underlined the severity of the test and emphasised that the valuation rates of interest used in 31/12/97 is stronger than the pricing basis which was used up to 1989."

88. The actuarial audit files contained correspondence between Headdon and the scrutinising actuary[2] at GAD. Headdon wrote, in response to an earlier letter, to confirm that policy values exceeded asset shares:

> "You are however, correct in deducing that at 31/12/96 the total face value of policies including accrued final bonus was in excess of the value of the assets attributable to with-profits business. Those assets will include items like the accumulated new business strains and so are higher than a pure share of the Form 9 admissible assets."

Audit were aware of the fact of the excess, and of the impact of excluding inadmissible assets for regulatory purposes.

89. The files for the 1998 audit did not disclose notes on valuation of liabilities other then in relation to the annuity guarantee issue already noted. The general valuation assumptions were dealt with more prominently in the 1999 audit.

90. At the planning stage for the 1999 audit, Ernst & Young identified two factors which they considered likely to have an impact on the Society's actuarial valuation. These were:

i. publication of revised mortality tables (CIMR 17) which suggested lighter industry-wide mortality; and

ii. a low interest rate environment.

Audit indicated that the firm's actuaries would review the reasonableness of the assumptions used in the actuarial valuation and the calculation of the deferred acquisition cost asset. The audit file included recently issued professional guidance with respect to relying on actuarial advice.[3]

91. The audit actuarial summary review memorandum revealed the following summary findings:

i. The valuation results appeared reasonable and to have been calculated using appropriate valuation methods and assumptions;

ii. There had been no large changes in the main assumptions, but the basis remained prudent in light of the underlying experience. The investment assumptions had been weakened in line with falling yields. The annuity mortality assumption had been strengthened;

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[2] See chapter 15, paragraph 42for an explanation of this term.

[3] Using the Work of an Actuary with Regard to Insurance Technical Provisions, APB, January 1998.

iii. There had been no material change in methodology this year, other than the move to Prophet from Beaugal;

iv. The increase in the Long Term Business Provision was due mainly to the effect of new business in the year and the strengthening of the annuity reserves;

v. The increase in Linked Liabilities was due to strong unit linked growth during the year and new business; and

vi. The DAC was lower due to contribution from new business being less than the amortisation of in force business.

The conclusion of the summary memorandum was:

> "Based on our review of analytical information provided by Equitable's Actuarial Department we have gained assurance that the reserves shown have not been materially misstated."

92. The actuarial audit reviewed changes of the valuation assumptions made for the year in comparison with the previous year. The review highlighted the following factors:

Interest rates

There had been a change in the annuity rate of interest, which had increased from last year. This was thought to be consistent with increases in the yields in the underlying fixed interest investments.

Mortality rates: annuitant mortality

The review stated:

> "We broke the mortality basis analysis into three parts: the current experience, the allowance for future improvements, and the margins in the valuation basis for prudence.
>
> The client has indicated that their current experience is PMA80/PFA80 (C=2010) -2, which was the basis that they used last year. We have questioned this for males, as the charts comparing the client's experience with this basis show that the client's experience is lighter than this. This does not initially seem prudent. However the client has explained that most of their policies are last survivor, for which the experience is more closely related to female mortality. The margins for females are more reasonable. A further and larger margin for prudence arises from the fact that the comparison charts exclude CPAs, which make up about 25% of the portfolio, and which tend to experience heavier mortality by about 2 years.
>
> We also considered the allowance for future improvements in mortality. To allow for this the client has used PMA80/PFA80 (C=2010) -3, ie an additional one year negative age rating has been adopted. To test the reasonability of this, we used the most recently published mortality tables, namely PMA92 and PFA92. Using these tables, it is possible to gain an insight into how recent mortality experience compares with expected future mortality experience, allowing for future improvements. We believe that the basis adopted by the client makes sufficient allowance for future improvements to mortality.
>
> [Our only concern is that the comparisons used are based on 100% spouse's annuity. A more realistic comparison should use 50%, and this shows a greater difference, as the male mortality is more significant.]
>
> The client intends to move to a basis this year, which uses the new tables. The new PROPHET system should facilitate this change."

93. The actuarial audit findings with respect to the valuation assumption changes were as follows:

i. The assumptions appeared reasonable for the calculation of the UK long-term business provision, with sufficient margins for prudence remaining.

ii. Based on the review of the work completed and discussions with the client, the actuaries were satisfied that the valuation results had been calculated using appropriate methods, assumptions and data.

iii. The changes in the AVP process had been reviewed and they concluded that the new controls in place were adequate to cover all of the risks. In addition, they were satisfied that the new valuation system produced the same results as the old system.

iv. The valuation methodology appeared consistent with prescribed methods.

v. The valuation assumptions had been based on the results of experience investigations. The firm's actuaries were satisfied that there were sufficient margins in the basis.

94. Audit's conclusions with respect to the actuarial valuation were noted to have been:

Revised mortality tables:

"In view of the change in valuation system the Appointed Actuary decided not to adopt formally the new tables and therefore has continued to use previous tables which are based on heavier mortality than the industry is currently predicting. In order to approximate such lighter mortality predictions management have strengthened mortality assumptions by one year (e.g. the assumption is now that a 55 year old will have the mortality previously assumed for a 54 year old). Our analysis has concluded that this approximation is reasonable in light of the Society's actual experience, the mix of males to females, the number of group cases and the number of compulsory purchase cases in the annuity portfolio."

Low interest rate environment:

"The only change to interest rate assumptions has been to the annuity rate of interest which was increased (from 4% to 4.25%) from last year. This is consistent with increases in the yields in the underlying fixed interest investments. This change appears appropriate given market trends and asset matching."

95. The position in relation to the 2000 audit was altogether more complex. It has been less easy to isolate valuation issues from solvency. There was clearly a perception that full recording of every aspect of Ernst & Young's work and thought was required. It had been noted in the 1999 files that the firm believed that it might not be re-appointed. The audit summary review was long and comprehensive.

96. The review noted that there had been regulatory changes affecting unitised with-profits (UWP) reserving and reinvestment rates. The reserving requirements for UWP business had been tightened up by FSA. The change in regulation was intended to make sure that UWP reserves sufficiently reflected policyholders' reasonable expectations with regard to surrender values. This change made the practice of discounting the face value of reserves difficult to justify if there was an expectation that fund adjustments would not apply on surrender.

97. In the light of the change, audit reviewed a range of Equitable literature and reviewed records of discussions between the Society and GAD. The Society did not discount the face value of reserves in the main valuation, but did do so in the resilience test. The Society had discussed this at length with the regulators, who had now agreed with their approach. Therefore, the Society believed that the change in the regulations did not affect them. Further it was noted that the with-profit guide

published in 2000 had stated the Society's policy on non-contractual termination, such as early surrender or transfer. The basis for calculating the surrender or transfer value was not guaranteed. It stated that the Society had, on occasion, found it appropriate to apply an adjustment so as to protect the interests of the remaining with-profits policyholders. Details of the adjustments that have been applied in recent years were set out. Similar statements were identified and recorded by audit in respect of a personal pension plan policy statement. Audit concluded:

> "We are satisfied that on the basis of this evidence, the approach of ELAS to the new UWP reserving requirements with regard to policyholder expectations are being met, and in particular that the approach used is appropriate having regard to our understanding of ELAS' ability to impose MVA's at its discretion. However we understand that the OFT is considering ELAS' imposition of a 10% (recently increased to 15%) MVA. And note that no provision has been made for any adverse consequences of the OFTs challenge."

It was noted that the resilience reserves were outside the scope of the work Ernst & Young had been instructed to do in relation to the statutory accounts.

98. The review set out the audit actuaries' understanding of the old and new regulatory rules determining the permissible reinvestment rates, and the calculation of Equitable's rates in accordance with the new requirement.

99. The files disclosed details of Ernst & Young's knowledge of and work relating to a number of specific valuation issues in relation to 2000. The general implications of the annuity guarantees have already been noted. In respect of the valuation of the liabilities, audit's notes contained comments on an apparent confusion over the application of a 5% reduction factor which GAD had allowed generally in the computation of annuity guarantee reserves. It was noted that GAD did not understand how the Society's application of an 85% take-up rate, implying a reduction of 15%, was consistent with the guidance. It was noted that:

i. The Society argued that the overall accumulating with-profit reserves was not reduced by more than 5%, (although the GAR part of the reserves was), and that this was consistent with DAA 13.

ii. GAD had stated in a letter of 4 December 2000 that, in their opinion, in the context of GARs being worth 30% more than current annuity rates, it would not be prudent to assume that more than 10% of policyholders would take cash or alternative benefits. This would lead to a minimum take up rate of 90%.

iii. The Society indicated to GAD that they would use a take up rate of 90% in their reserves calculation.

iv. In a discussion on the future premium assumption built into the calculations, GAD questioned the prudence of using 20% in the past in the light of 25% experience, noting that Ernst & Young reports contained a realistic assumption of 10%.

v. The Society stated that they intended to strengthen the basis, and GAD acknowledged that intention.

100. In relation to accumulating with-profits business generally, GAD had queried the strengthening of the basis for personal pensions due to reducing the assumed retirement age from 60 to 55. The Society had explained that this was due to experience as earlier retirements had pulled down the experienced retirement age. GAD had responded that the new valuation regulations indicated that age 50 should be used where cash payment could be secured at that age. The Society responded to say that they couldn't see why. GAD responded by saying that was their current view based on their reading of the new regulations. GAD asked for details of the range of ages at which policyholders could exercise retirement options without penalty, and at what age the GAR benefit could be taken. The Society had responded that the age ranges were between 60 and 75 for retirement annuities, and between

50 and 75 for personal pensions. GAR could be taken between 60 and 75, and did not apply to personal pensions. GAD had thanked the Society for this information.

101. In relation to resilience testing, the files noted further exchanges. GAD had asked what retirement ages had been assumed for the purposes of the resilience test, given the wide time interval over which the Society was exposed to varying investment conditions. The Society responded saying that the ages were as stated above. GAD responded to say they were happy with this answer. GAD had asked what the impact would be of the new resilience test 2 on the Society, and whether consideration had been given to weighting the valuation interest rate by amounts and duration of the assets held. The Society believed that the effect would be a reduction of approximately £300m which was about half of the difference between the old and new test 2. Overall, the reserve would not change – the main reserve would increase by a small amount, and the resilience reserve would fall by a small amount. GAD had also queried the effect of the possible benefit to the Society by using a more sophisticated (and justified) set of hypothecations. The Society replied that the effect would be an approximate £750m reduction in resilience reserve, though the result would be a trade off between this result and the result from the paragraph immediately above.

102. Exchanges between GAD and the Society about the Society's use of a zillmer expenses adjustment were recorded at some length. GAD had queried the ½% p.a. deduction of benefit value that was taken for each year up to the date benefits were taken (which, Ernst & Young noted, operated as an adjustment in respect of un-recouped acquisition expenses). GAD had asked how it was calculated on recurrent single premium (RSP) products, what margins were available from future premiums (or elsewhere) to provide for the charge, and whether it was consistent with PRE to assume that in the case of mass discontinuance the outgoing policyholders suffered a charge in respect of un-recouped acquisition costs. GAD had also asked for any product literature that supported the Society's approach.

103. The Society had replied that there was an explicit 4½% standard charge on premiums and although this has been rebated in the past, there were no guarantees that this practice would continue into the future. The Society also stated that they believed that any charges at discontinuance was consistent with PRE – they supplied a policy booklet, key features document, annual statement of benefits and with-profit guide to emphasise this point. GAD had replied that they were still concerned about the use of a zillmer adjustment on RSP business – they were having difficulty accepting that the liability for accrued benefits could be reduced first by assuming that policyholders would pay future premiums, and secondly by assuming that a 4½% charge would be applied to them. GAD felt that in a closed fund situation it would be unlikely that policyholders would continue to pay additional premiums (unless there was a clear advantage to them – e.g. existence of a GAR) and the 4½% reduction would act as a further deterrent to premiums. GAD also felt that it was not permissible to use either margins within the future profits implicit item or possible changes in regulations as possible sources to recoup the ½% allowance on accumulating with-profits business that the Society had assumed in the resilience scenario. GAD also felt that the ½% allowance was not consistent with regulation 67(3) or 72. GAD had gone on to state that this valuation assumption would not be acceptable in the 2000 returns.

104. The Society had accepted this decision, although making the point that it led to a very prudent overall reserving basis for with-profits business. GAD thanked the Society for the documentation that backed up the "charges and PRE" issue and said "we agree that this would appear to support the Society's assumptions regarding mass discontinuance in the resilience scenario".

105. Audit noted that in the same correspondence, GAD had raised a further issue – why the expense provision for pensions accumulating with-profits business reduces from 2% in the base scenario to ¼% in the resilience scenario. In reply to the expense query, the Society had stated that it was inappropriate to hold

unnecessary margins in expenses and had reduced the assumption closer to the 1999 expenses experience (form 41, line 44, 1999 expenses = £36m c.f. the reserved amount of £74m). The Society went on to say that the 2000 expense assumptions were being reviewed, which was noted by GAD.

106. Finally it was noted that in the correspondence GAD had sought to determine what impact the tightening of the reserving rules on treatment of surrender values would have on the Society. Consistently with the findings already set out, the Society had indicated that, as no reserving basis on surrender was guaranteed, there would be no impact on the reserves due to this change. The GAD thanked the Society for the information.

107. This extensive review of GAD correspondence was not reflected in work or expressions of opinion by audit. Much of it appeared to be included for record purposes, subject only to the comfort audit no doubt drew from GAD's acceptance of the Society's practices, or promises about future practice.

108. The audit summary review memorandum noted that bonus allocations for the first seven months of 2000 had been withheld to allow for additional reserving to provide for the annuity guarantee liability. No guaranteed reversionary bonus for the year had been declared. Instead a non-guaranteed amount equating to 3.3% over the whole year had been added to terminal bonuses.

109. In their report to the Board on the results of the audit, comments were made by audit with respect to bonus and the sale to Halifax. It was noted that:

i. The Society had offered policyholders whose policies matured during the period when bonuses were suspended a contingent terminal bonus. The bonus offer was predicated on goodwill arising on the sale of the Group exceeding £1 billion.

ii. As no sale proceeds had been recognised in the accounts for the year ended 31 December 2000, it was not appropriate to accrue the cost of any contingent bonuses.

iii. As the overall goodwill might not reach the £1 billion threshold, the contingent liability needed only to be recognised in the context of the post balance sheet events disclosure related to the Halifax transaction.

110. In their report to the audit committee on the audit results, audit raised a number of issues relating to the actuarial valuation. They commented that the appointed actuary had the statutory responsibility to maintain the solvency of the Society and to report to the regulators. The Society had not at the date of the report prepared the regulatory return to FSA as at 31 December 2000; it was not due until 30 June 2001. They noted that as part of the audit process they had met with the new appointed actuary and with the chief executive to discuss changes to the key assumptions made in arriving at the actuarial estimate of the technical provisions and the reasonableness of these assumptions.

111. They set out the main assumption changes:

Annuitant Mortality

The mortality basis for male pension fund annuity business had been strengthened for both non-profit and with-profit business based on experience for the period 1995 to 1999. This showed that experience for males was close to the valuation assumption used last year. Therefore, the basis was strengthened by the –1 age adjustment. As this gave a margin of only 2%, the progress of mortality experience on this business would need to be monitored carefully.

Interest Rates

Over 2000, the FT gilt indices had reduced at each age and had led to the Society dropping annuity valuation interest rates from 5¼% to 4¾% for post-

1991 annuities, and from 5¾% to 5¼% for pre-1992 annuities. The move in the assumptions was said to be reasonable in the light of the underlying move in the indices, allowing for the different outstanding term of each of the pre-1992 and post-1991 groups of annuities.

Future Expenses

The closure of the Society to new business had the obvious result that all future expenses incurred by the business would have to be met out of margins present in contracts written prior to closure. Although the ongoing costs of managing the closed fund might reasonably be expected to decrease over time, the Board would need to be satisfied that existing margins were adequate particularly in the immediate future while transition costs were being incurred and ongoing costs were still relatively high. Analysis carried out by the Society's actuarial department following the fund's closure had shown that, excluding £15m of non-recurring expenses incurred in 2000, recurring expenses of £46m were covered by product loadings in excess of £60m. Although this suggested that there was adequate coverage, audit recommended that the appointed actuary monitored this situation on an ongoing basis.

Solvency

112. In the course of the 1990 audit, Ernst & Young reviewed board minutes and papers. The auditors became aware that the Society's regulatory solvency cover ratio had reduced from 5 in 1989 to just under 2 in 1990. They noted that Ranson had indicated that this fall was comparable with other offices and that some commentators might try to take advantage of the apparent weakening of the Society. The auditors noted the terms of a board minute in which Ranson represented to the Board that the Society was in a "strong financial position", but was a little tight in terms of regulatory requirements. They raised some concerns over the level of regulatory solvency brought out by the Society's figures. The "weakness" in the current liability valuation method raised auditors' concerns that there might be a risk of potential solvency problems in the forthcoming year. It was noted that under the Society's former approach to valuation, a transfer from reserves would have been necessary to support bonus.

113. In the course of the 1991 audit, the auditors raised concerns over the low excess margin of solvency, of only £80m, over the required minimum margin. This concern was raised at a supervisory audit file review stage and appeared to have been addressed by a meeting with management. However no evidence of this meeting and of what was discussed was found on file.

114. From their review of board papers, dated October 1991, the auditors confirmed that solvency remained a topic of discussion for the Board in 1991. The appointed actuary, Ranson, had expressed his 'mild discomfort' at the technical weakness on form 9 of the regulatory return. While he acknowledged the need for a mismatch reserve it was noted that it did not appear that he was prepared to raise such a reserve because he had applied for a section 68 order to allow for future profits to be taken into consideration in the form 9. It was noted that Ranson felt confident that he would be successful in his application because he had a good relationship with GAD and DTI and he had "a great deal of confidence" in Michael Pickford, the directing actuary at GAD dealing with the Society.

115. At the time of the 1992 audit, Ernst & Young's records show that they had a view of the external economic environment and its impact on life offices in general across the industry. With this in mind, Bannon sent a memo to McNamara making him aware of the relevant issues facing these offices:

i. Weak equity markets had placed solvency pressures on life offices, forcing some to sell equity holdings and switch into fixed income

investments. This action further exacerbated the continuing weakness of the equity market.

ii. Bannon indicated that Equitable should be aware of its maturity profile, as a number of insurance companies were facing a significant increase in expected maturities over the forthcoming years, which could have serious implications for solvency. The counter measure suggested by Bannon to maintain solvency was a reduction in terminal bonus rates. Bannon concluded by saying: "overall I think that Equitable continues to be one of the stronger mutuals".

116. It was noted that the effect of weakening the valuation as against what had been intended earlier in the year had the effect of providing a form 9 solvency position of similar strength to that of 1990 rather than a weaker one.

117. 1993 was a year of high returns. No matters of significance in relation to solvency were identified for this period in the files.

118. In the course of the 1994 audit, solvency was again an issue. After discussions with Ranson, Grenham of the Ernst & Young's actuarial team reported to audit that:

i. While Equitable was a successful company it was financially weak and was vulnerable to a sustained period of poor investment performance.

ii. Ranson used the weakest possible valuation and even then free reserves only represented 3.4% of liabilities (1993 – 11%).

iii. He, Grenham, suggested that in such a situation the Society would have to start cutting bonuses quite drastically, and possibly more drastically than many of its competitors due to its lack of free reserves.

iv. Ranson had acknowledged that while the Society was commercially successful it had little free capital in relation to total assets. He went on to indicate that there would be cuts in terminal bonuses unless equity markets improved.

119. In the audit files for the following year, 1995, there was increased focus on the Society's level of solvency. The auditors found evidence of this from their review of the board and investment committee minutes. The investment committee had commenced reviewing solvency on a monthly basis, while the Board was presented with quarterly graphical representations indicating the values of:

i. non-linked liabilities;

ii. statutory solvency margin; and

iii. free assets.

120. In their review of the year's board papers, the auditors became aware of Ranson's views with regards to demutualisation. It was noted that in a 'future strategy' paper for the Board he had expressed the following views:

i. The Society's finances were considered to be well under control as all costs were within those anticipated in the premium bases;

ii. There was for all practical purposes, no shortage of capital ie the Society suffered no disadvantage from its mutual status; and

iii. There were no current problems with meeting statutory solvency requirements.

121. Ernst & Young sent a monthly insurance newsletter to the Society. In October 1995 the letter was entitled 'Creeping Insolvency'. It raised a number of points. It suggested that non-executive directors of life offices might want to consider the following issues:

i. Not all the surplus represented by the difference between assets and liabilities would be available as 'free capital'.

ii. Part of this surplus would need to meet the cost of terminal bonuses, and the amount would be determined using assets share techniques.

iii. It was, of course, true that until the terminal bonuses were paid, the relevant funds were available for investment, including investment in new business, but care needed to be taken in matching cash flows, taking into account the maturity profile of the with-profits portfolios.

iv. The non-executive director might therefore ask the Appointed Actuary to demonstrate the level of free capital after allowing for terminal bonuses and additional capital required to smooth bonuses.

v. It was quite possible that the resulting free capital could be negative, which would indicate an urgent need to reduce bonus rates and move to a lower risk investment strategy.

122. Headdon responded to Ernst &Young stating:

"I was very interested in the above newsflash on questions a non-executive director of a life office might ask the Appointed Actuary. There was, however, one point, which caused me some concern. That was the suggestion on page 3 that, if the free capital after allowing for terminal bonuses is negative, that indicates an 'urgent need to reduce bonus rates and move to a lower risk investment strategy'.

If one considers a with-profits mutual which operates on the 'revolving fund' principle with no estate and which aims for a 'full distribution' policy, then, on average, policy values including terminal bonus should be above underlying asset values half the time. (They would, of course be below for the other half of the time.) For such an office that is what smoothing would mean."[4]

123. Bannon replied on 8 November saying,

"I agree entirely with the points you make regarding free capital in the context of a revolving fund principle with no estate".

He agreed that the sentence quoted by Headdon should therefore be qualified. He added,

"I have to say I am very much in favour of the "full distribution" policy, but when I wrote the article I had more in mind those offices which maintain a cushion of free assets to facilitate smoothing."

124. During the audit, discussions were held by the auditors (Woodridge & Grenham) with Headdon on the Society's solvency position. Headdon indicated that the solvency margin was improving and he expected a £200m improvement at the year-end. He also went on to indicate that solvency was measured by monthly estimated valuations done to monitor the solvency margin. From these estimates he would then produce monthly reports on free assets for Ranson.

125. During the 1996 audit, Ernst & Young obtained and reviewed a paper prepared by Nash and Headdon setting out the Society's projections for the period 1997 to 1999. The issues under discussion that were revealed by this paper included:

i. The predicted solvency position at 31 December 1997, based on 'optimistic, most likely and pessimistic' investment performance.

ii. The options for the Society to improve solvency if the pessimistic scenario occurred, which assumed investment returns of negative 3%. These solvency options included subordinated loans and passing on a bonus declaration.

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[4] See also quote in chapter 6 at paragraph 47.

iii. The conclusion that the office had a number of measures available to it. Consequently there was no need to take avoiding action at an early stage merely because a position of regulatory difficulty was seen as an outcome of a possible scenario (but one which might well not happen.) Provided that the solvency position was kept under regular review, as it was in the Society's case, and the full implications were kept in mind when deciding bonus rates, there was no need to allow regulatory considerations to influence behaviour until it was felt that an unsatisfactory outcome was reasonably likely without some change of direction.

iv. Payments to policyholders were well ahead of what had been forecast, due to an unexpectedly high level of retirements under individual and personal pensions.

The auditors performed a financial statement analysis, comparing the Society's published results for the past 5 years with those of Standard Life and Scottish Widows. This comparison revealed that Standard Life and Scottish Widows had significantly higher free asset ratios than the Society, in addition to showing the higher proportion of investments held in fixed interest securities by the Society.

126. The files for the 1997 audit noted that the investment committee continued to receive monthly reports prepared by Headdon, which included a solvency matrix. This analysed the current free asset position of the Society and showed the change in free asset ratio under various market scenarios. The discussion of the solvency matrix included comments as follows:

> "In Form 9 of the DTI return an office has to compare the value of its assets with the reserves to cover policy liabilities (calculated in accordance with regulations.) The reserves need to take into account all guaranteed benefits, including declared bonuses, but not final bonuses. The difference between the assets and the reserves are the available assets for solvency purposes."

127. The actuarial audit files included extracts from board papers which discussed the Society's statutory solvency position and relevant counter-measures to support this position over various time periods. Possible responses to adverse conditions were set out as follows:

i. Very short-term

   a. Increased use of future profits implicit items;

   b. Declared bonuses could be reduced; and

   c. Assets could be switched to higher income bearing gilts/equities.

ii. Short or medium term

   a. Financial reassurance arrangements - Headdon commented that reassurance brought forward future profits and that the DTI might limit the implicit item; and

   b. Increase subordinated loans.

iii. Longer term

   a. A balance had to be struck between providing guarantees, which were attractive to clients, and avoiding those that were unduly onerous in solvency terms; e.g. 3.5% guaranteed interest rate;

   b. The rate of growth of new business on products, which create a solvency strain, could be reduced.

128. The audit planning section of the files for this year contained a client risk profile, which was in the form of a questionnaire that contained a section relating to the assessment of client solvency issues. Under the question, "Do you have any concerns in respect of your client's ability to continue as a going concern?", was

marked the response "Possibly." Accordingly audit identified solvency as being a specific audit risk, which was to be addressed appropriately.

129. As mentioned at paragraph 84 above, the audit file contained a general report produced by Clive Letchford which included reference to solvency.

130. The auditors carried out a SWOT (strengths, weaknesses, opportunities and threats) analysis of the Society. This analysis identified that the Society had a low free asset ratio, which was regarded as a weakness. The analysis also included the following audit commentary:

> "ELAS maintains a low free asset ratio, maximising payout to policyholders. Solvency may be threatened by reduced premium and investment income and increased claims."

The auditors gained some level of comfort from the Society's own solvency management processes which involved:

> "The process whereby regulatory requirements and current margins are reviewed and action taken by management to address any issues."

This was taken to provide some assurance on the adequacy of the solvency margin and measurement of this in the accounts.

131. The Ernst & Young actuarial manager, Farrelly, held an interim meeting on actuarial issues with Headdon and Loseby to discuss the Society's solvency position. The meeting notes referred to a discussion of the Society's use of 'traffic lights' to establish solvency status, and a comment by Headdon that he did not have quite the same 'status' as Ranson, and that he was asked to present and explain issues that Ranson would not have been asked about.

132. The record of a meeting held between Bannon and Combes of Ernst & Young and Headdon contained the following comments, among others:

> "Chris prepares monthly reports which show free assets as a multiple of solvency margins. Two or three times solvency margin is considered adequate. ...
>
> Chris agreed that he was walking a tightrope. ...
>
> As soon as the solvency position changes from green, action is taken to increase the degree of investment in fixed interest and this can quite readily be done by redirecting the very strong positive cash flow currently experienced."

133. Farrelly prepared a report entitled 'ELAS Management of Solvency Position' which supported the Society's solvency position. He noted:

> "Equitable Life's policy of full distribution, along with recent strong growth, will result in a low margin of free assets. ...
>
> These higher ratios [of competitors] reflect the different distribution policies of these Life offices. ...
>
> Investment management reviews solvency matrix monthly for potential equity/gilt price fall scenarios. ...
>
> Additional solvency management through short/medium and long-term items. The implicit items, subordinated debt and reinsurance options are all considered reasonable."

134. The auditors identified correspondence from Tritton, the chairman of the audit committee, to Nash which highlighted Tritton's concerns about the solvency position of the Society. The terms of Tritton's letter were noted:

> "In general and as Chairman of the Audit Committee, I am satisfied that there is proper recognition of the risks undertaken by the Society and that the necessary control mechanisms are in place for the management of these risks. I have, however, one caveat and this may or not be a personal view, I do not

know. However, it is my belief that the Equitable as a mutual is managed too close to the margin. Now I know and I understand and appreciate all the reasons why this should be the case and philosophically do not disagree with the tenets of full, fair and equitable distribution of annual surpluses. However I do believe that there is an increasing risk to the independence of the Society from this annual desire to distribute to the limit. I also observe rightly or wrongly that the effect of such a distribution policy is beginning to tighten our position. If it is not, why are we going down the subordinated loan stock route, why are we taking in more and more from future profits and so on. It may be that this all results from greater proportion of fixed interest stocks in our investment portfolio compared with other houses - I really do not know. All I know is that I am beginning to feel uncomfortable with the business being run so close to the margin and that this could well be the greatest risk we are running."

135. Nash's response to Tritton was also noted. It included the following comments:

"The first point I would make is that I do not believe that it is the annual distribution of surplus as declared bonus which is a major contribution to the tightening of margins you describe. ...

It is unarguable that the valuation regulations are more stringent in a low interest rate climate, that the 1994 regulatory changes reduced the room for manoeuvre and that the removal of dividend tax credits has led to higher reserves on pension business."

Nash then compared the 1992 solvency margin of 2.4 to the 1997 figure of 2.4/2.5, to show that there had been no deterioration, and said:

"If the Board wants significant improvement in the margin of solvency then either a) give greater emphasis to fixed interest stocks, however ELAS would under perform the market. b) retain a significant proportion of earnings from maturing policies. This could take a number of years to generate significant free assets. c) reduce new business levels significantly. Increases vulnerability to predator. d) reduce significantly, or eliminate declared bonuses, as discussed in January Board meeting."

136. The auditors advised management (Headdon) that in accordance with the actuarial profession guidance and best practice, they should be preparing a financial condition report (FCR), with the following characteristics:

i. An annual report was required, usually 20-30 pages in length;

ii. The report should consider the future solvency position of the company for at least five years from the current date; and

iii. The report should perform sensitivity analyses on all the key assumptions.

Headdon resisted the recommendation that such a report should be prepared. He considered that the information the report would contain was already being provided throughout the year to the Board. Bannon, the Ernst & Young actuary, expressed the view that the Society's appointed actuary's view was against the current view of the Institute of Actuaries in this regard.

137. However, it was recorded that Ernst & Young were asked by John Sclater on behalf of the audit committee to provide them with background information about a financial condition report. This information appears to have been edited (at the request of Headdon) as follows. First, from the phrase:

"... the FCR will inform the Board of the solvency in the medium term (typically 5 years) under different scenarios",

the comment, "typically 5 years," was removed. It was commented that the Society did not do projections so far forward and therefore it would appear important for the

executive and non-executive directors to be aware of what was generally seen as a medium term timescale. Second, the sentence:

> "I enclose as an appendix to this letter a summary of the key features."

was removed from the final letter, along with the appendix. And third, Headdon added a comment that a financial condition report was not required if the designated information had already been provided to the Board.

138. It was recorded that Headdon had commented to the auditors that he was intending to report to the Board that a financial condition report was not necessary and that his current method of continual appraisal was in his view better. The following two extracts from his paper as presented to the Board were noted. First, in relation to five-year projections:

> "For a predominantly with-profits office, such as the Society the value of such long term projections is debatable. The projection of solvency difficulties in five years time resulting from certain combinations of adverse conditions is not helpful unless the modelling of how the office would have responded to the emerging conditions is realistic."

And:

> "For example, projecting that the office would be insolvent if current declared bonus rates were maintained, when the set of future conditions is such that rates would certainly be reduced in those circumstances adds nothing to ones understanding of the business."

139. Bannon concluded in a memorandum that in his opinion Headdon's approach was satisfactory and covered the required areas, albeit not in a single annual report. He said that it was, of course, up to the Board to tell Headdon if they decided they wanted such an annual report, and they might well do so. The auditors indicated that most actuaries at that stage produced financial condition reports which incorporated the fund results and the financial position of the entity both currently and under future scenarios where different assumptions were used.

140. In the 1999 audit solvency was identified as an area of interest at the planning stage. The auditors made a risk assessment with respect to strains on statutory solvency, identifying the following factors among others:

i. The combined effect of declining investment values and low fixed interest security yields; and

ii. The appointed actuary's practice of active monthly monitoring of the Society's solvency position, involving stressing solvency under varying scenarios and recommending appropriate actions to the investment committee.

141. The auditors continued to identify 'possible' concerns over the Society's ability to continue as a going concern and it was noted that there was a high likelihood of (continued) business deterioration. Additionally, they identified public criticism and litigation with respect to the Society's business practices as an issue. The auditors reviewed a Board paper prepared by Headdon, which revealed that no solvency matrix had been prepared for the Board as at 31 March. The explanation given was that the resource commitments involved in preparing the "accelerated HMT returns" made the preparation of the solvency matrix impractical. Headdon indicated that equity markets had moved up 8% since year-end and there had been a small increase in interest rates. He expected that there would be some improvement in the solvency cover ratio, estimated at that time to be around 2.5x.

142. In their review of the regulatory return, the auditors noted in their summary review memorandum that they were satisfied with respect to the reasonableness of the valuation bases used to calculate actuarial liabilities at 31 December 1998, taking account of a resilience reserve of £700m (1997 - £400m), and implicit future profits items, which had risen by £480m. They also noted that that the Society had

received two separate section 68 orders for implicit future profits for 1998. The first, for £850m, was received on 25 September 1998 and the second was issued in December for £1.9 billion, which was to replace the first order issued. While no documentary evidence was seen by audit, Headdon confirmed that the second section 68 order was issued to cover the risk that reinsurance for the annuity guarantees was not obtained. In the event, reinsurance was obtained, and the first order was then applied. Headdon indicated that he had telephoned FSA on 26 March 1998 to confirm that this treatment was acceptable to them.

143. In their review of the regulatory return, the auditors commented that a credit of 50% of the subordinated loan capital value (the maximum permitted) was disclosed in lines 26 and 27 of form 10 and should be taken into account in computing regulatory solvency[5].

144. In planning for the 1999 audit, Ernst & Young prepared a planning report for the audit committee. In the report Ernst & Young highlighted, in respect of solvency, the following key areas of focus for them during their audit:

i. actuarial valuation and analysis of surplus;

ii. other strains on solvency; and

iii. regulatory compliance.

Ernst & Young also noted that 'solvency strain' and 'fundamental breach of regulations' were key business risks for consideration by them during their audit.

145. It was noted that the financial position of the Society was a key concern for its members and that any new strains on solvency could have an effect on levels of new business and surrenders. In addition to the firm's normal audit work on the statutory return Ernst & Young's actuaries would discuss with management the various scenarios that the Society had modelled and the likelihood and impact of potential adverse experience that could occur.

146. The auditors reviewed the Society's solvency management process, which was under the control of Headdon. The objective of the process, as noted by the auditors, was:

"To maintain solvency at an acceptable level whilst, at the same time, fulfilling the Society's policy of full distribution and holding a mix of investments most likely to maximise the value of policyholder bonuses."

147. The audit files recorded that the auditors had identified the recurring reports generated as being:

i. Reports to the Board:

- Monthly reports showing the balance sheet and the estimated solvency position;
- A more detailed quarterly assessment of the emerging solvency position with commentary on trends; and
- Annual financial projections for the following three years incorporating one-year solvency projections on a range of scenarios.

ii. Reports to the Investment Committee:

- Monthly solvency information incorporating a matrix of solvency positions under a variety of scenarios with 'traffic lighting' to help interpretation.

148. The audit review carried out on the regulatory return highlighted the auditors' initial estimate of the long-term business fund, as at 31 December 1999, at £26 billion. This figure included a resilience reserve of £1.55 billion (£1998 - 700m)

[5] Compare paragraph 151 below.

which was calculated on a basis consistent which that of the prior year. Ernst & Young continued to have 'possible' concerns over the Society's ability to continue as a going concern and it was also noted that there was a high likelihood of (continued) business deterioration. Additionally, audit identified public criticism and litigation with respect to the Societies business practices to be an issue.

149. The auditors' conclusions with respect to the solvency of the Society included:

i. The appointed actuary actively monitored the Society's solvency position. He advised the Investment Committee each month of the effect on solvency of a range of scenarios concerning reductions in the market value of equities and changes in fixed interest yields. There were a number of actions that the Society would take if solvency dropped significantly, e.g., reduce bonuses and/or a switch from equities to fixed interest securities, although either of these could have a detrimental effect on the Society's future business.

ii. Ernst & Young's actuaries had reviewed the Society's valuation reports and had satisfied themselves that the appointed actuary's approach had been reasonable. On the specific matter of the annuity guarantees, they had reviewed the Society's analysis of its exposure and had concluded that the reserve for these had weakened the Society's position. Actual solvency had increased considerably towards the year-end as a result of market movements. However this position was reversed in January 2000.

150. The auditors reviewed the Hyman Court of Appeal Judgment of 21 January 2000 and acknowledged that there had been a 2:1 decision 'in favour' of the appeal. The audit file contained these notes of the judges' conclusions.

151. The audit files also contained notes on implicit items for future profits and the subordinated debt. In respect of the former it was noted that a section 68 order had been obtained by the Society on 19 November 1999, which allowed implicit future profits up to a maximum of £1 billion to count towards the required margin of solvency. In respect of the subordinated debt, the file noted that an additional section 68 order had been obtained by the Society on 19 August 1997 which enabled the Society to disregard, for the purposes of regulation 60 of the 1994 regulations, amounts owed under a loan agreement dated 4 August 1997 up to an amount not exceeding 50% of the Society's required margin of solvency.

152. Treatment of the annuity guarantees was a live issue for the 2000 audit as discussed above. In addition, the audit planning report to the audit committee highlighted the following key areas of focus for Ernst & Young during their audit, in relation to solvency, namely:

i. progress on the sale process, impact on the format of the accounts and the going concern basis of accounting;

ii. actuarial valuation and investment valuation;

iii. risk management and compliance with the Turnbull guidance; and

iv. regulatory compliance.

153. At audit planning stage, the auditors made an assessment of the audit implications of the sale of the group as a going concern:

i. The process aimed at selling the Group would continue throughout the year-end procedures and would result in a significant demand of senior management time in the coming months.

ii. Given the financial position of the Society, until a sale is agreed the Directors will need to justify the preparation of the accounts on a going concern basis.

iii. The management of data-rooms, vetting of potential purchasers, management of advisors and communicating to policyholders could divert

the attention of the Directors from business as usual issues during this period.

iv. Ernst & Young would assess with management in the coming months and at the year-end the Society's basis for treating the business as a going concern. This assessment would depend on the continuing business of the Society and the progress of the sale process.

v. Audit testing would assess the extent to which key controls such as suspense accounts were being maintained during this demanding period. This testing would take place in September and November and the audit findings would be communicated to management during those audit visits rather than post year-end.

In their risk assessment, the auditors continued to have 'possible' concerns over the Society's ability to continue as a going concern and it was also noted that there was a high likelihood of (continued) business deterioration. The auditors went on to assess the finance director's competence as being weak.

154. Ernst & Young presented a report of findings relating to solvency and the going concern basis, to the Board. Papers presented to the Board in January had shown that there was a draft solvency position on the regulatory basis as at 31 December 2000 of 1.3%, which reflected £350m in assets. This had demonstrated that there was a clear solvency risk for the Society, and that affected the issue whether the company should be regarded as a going concern. Ernst & Young commented:

i. That the risk at the date of the report was that the Society could become insolvent on a statutory basis, which was a conservative basis, and was defined after deducting the required minimum margin. If the margin were breached it would not be the end of the road. The Society would then have to present a plan to the regulators showing how they intended to regain solvency.

ii. Since the year-end, there had been a significant switch into gilts, which had improved the statutory position by £500m. Also, the initial £500m payment from the Halifax was expected to be received in the immediate future. However, market movements since the year-end had reduced the free assets by £300m. The net effect of this on the FSA basis was to improve solvency to 3.1%.

iii. If a satisfactory scheme could be found to settle the annuity guarantee issues, an additional payment of £250m would be due from Halifax. An additional £250m would be available if the sales force were successful.

iv. The company was closed to new business. There would not be new business strain. All other things being equal, this should progressively improve the solvency position of the fund.

v. The equity-backing ratio of the fund was currently 62%. Whilst this was lower than an average ratio for an open fund, it appeared high when contrasted with other closed funds. Ernst & Young recommended that the Society adopt a mechanism such as an asset liability model to test the suitability of its investment profile on an ongoing basis.

vi. The auditors had been told that a paper on managing closed funds (including the use of asset liability modelling) was being prepared by advisors of the Society.

vii. The solvency position included an implicit item of £1bn for future profits (correspondence with GAD had indicated that this was part of an allowable future profits amount of £2bn). This excluded margins payable under the reinsurance contract with Irish European Reinsurance Company. Under the Financial Services and Market Bill, this would no longer be available to support solvency.

viii. The Society was in close and regular contact with the FSA in order to manage the company in an appropriate manner, with due regard to policyholders' interests and the regulators' requirements.

155. In their report to the audit committee on the audit results, Ernst & Young raised the a range of issues in respect of the appropriateness of applying the going concern basis in preparing the accounts:

i. As a result of the Society closing to new business and due to well-publicised concerns over its solvency many readers of the accounts would question the appropriateness of the going concern basis of preparation.

ii. The going concern concept was defined in accounting standards as follows:

> "The enterprise will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation."

An important consequence of such accounting requirements was that, when preparing the accounts, the directors should satisfy themselves as to whether the going concern basis was appropriate, as they were obliged to make a specific statement to that effect.

iii. The auditors had recommended to the audit committee that the Board formally consider and resolve this issue at its March 2001 meeting.

iv. Notwithstanding the importance of such consideration by the Board, factors which might indicate that the Society continued to be a going concern were:

a. although the Society had closed to new business, it continued to transact in-force insurance business;

b. the appointed actuary had stated that the Society continued to meet solvency requirements; and

c. the Halifax transaction had generated £500m since the year-end and might realise a further £500m for the Society.

v. There was however uncertainty about the quantification of the annuity guarantee provision, and the Society's inability to cap the GAR liability would have the impact of curtailing investment allocation and would make solvency very tight if markets fell further.

vi. Ernst & Young considered that the statement made by the directors about 'going concern' should reflect the decision to close the Society to new business.

vii. Ernst & Young had prepared a comprehensive technically based guidance note on going concern, to assist the directors in carrying out their duties with regard to determining the appropriateness of the going concern assumption.

156. The actuarial audit summary review memorandum included the following with respect to the analysis of surplus:

> "An analysis of surplus is not carried out until later in the year. We believe that this should be brought forward as soon as possible. Charles Thomson has been asked to prepare a paper for the Board meeting on 28 March 2001 setting out the expected financial position of the Society in the 12 months following the signing of the accounts.
>
> This will form an important part of the Board's consideration of the going concern question."

157. Ernst & Young noted findings relating to the transaction with Halifax plc as a relevant post-balance sheet event. They reported to the Board:

i. On 5 February 2001 the Society had signed a deal with the Halifax plc for the sale of its operating assets, sales force and its non-profit and unit-linked business for a payment of up to £1 billion into the with-profits fund. The with-profits fund remained a mutual and closed to new business.

ii. On 1 March 2001 the Society had received £500m with the potential of a further £500m if certain conditions were met. £250m would be received if the Equitable achieved a settlement between the guaranteed and non-guaranteed annuity rate policyholders and a further £250m would be received if the sales force achieved certain sales targets by 2004 (also contingent on the settlement being achieved). The sale was not subject to a members' vote because the with-profits fund would remain a mutual. The 2000 accounts did not include any benefit in relation to the post year-end receipt of the first £500m or a favourable outcome of a GAR settlement.

iii. Halifax had two main life assurance operations: Halifax Life and Clerical Medical.

iv. Details of this event were disclosed in note 22 to the accounts.

158. Ernst & Young's report to the audit committee noted that the 2000 FSA return would take benefit for the present value of future margins amounting to approximately £1 billion[6]; that the inclusion of this implicit item had been approved by the FSA during 2000; and that FSA had also reviewed and approved the current GAR reinsurance treaty. The report further noted that for the purposes of the regulatory return it would be necessary to make several adjustments to the valuation of assets and liabilities used for the purposes of the Companies Act accounts. The principal adjustments, in addition to the implicit item, and their effects, were identified as the need to provide for a resilience reserve of £1.8 billion, and the removal of the balance sheet value of deferred acquisition costs of £190m. It was stated that amounts that might be received by the Society under the GAR reassurance were repayable out of future margins to the extent that such margins arose. Since FSA had reviewed and approved both the calculation of the implicit item and the latest reassurance treaty Ernst & Young said that they were satisfied that there was no double counting of future profits between these items.

159. Other solvency points were discussed in the later stages of the 2000 audit. However, since reporting for this year represented Ernst & Young's record of audit overall, it will be more appropriate to deal with these late reports together, after commenting on other audit issues of a repetitive nature over the period.

<u>New Business</u>

160. New business was a focus for audit review throughout the period. In the course of the 1990 audit Ernst & Young reviewed correspondence between Ranson and GAD, in which GAD raised, in particular, the need to reserve for policy surrenders and for possible new business strain, especially in the light of the Society's 'full distribution' policy. This issue was raised specifically with respect to with-profits bonds, but alerted audit to these reserving issues more generally.

161. In the course of the 1991 audit, the auditors reviewed press releases relating to the Society that had been issued during the year. From their terms, the auditors were alerted to an unusually high increase in single premium business sold by the Society. They questioned the resulting level of financing strain, and there were discussions between audit and the appointed actuary on this topic. The auditors noted that they had been told that as at the end of 1991 the accumulated effect of

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[6] 1999: £925m.

financing new business strain was £250m. The Society's approach to managing such strain was to 'lend' the necessary sum from policyholders' funds to a notional management company. The debt would then be repaid to policyholders on their departure from the fund as a factor in the terminal bonus mechanism.

162. The topic was reviewed again in the course of the 1992 audit. From a review of board minutes, the auditors identified the Society's policy and approach to dealing with new business strain. The item was again estimated to have a value of £250m at year-end. Auditors discussed the matter with Headdon, who indicated that the rate of growth in the loan value was slowing as the Society was beginning to recoup its costs from periods of high new business growth. The auditors concluded that financial strain would not affect the ability of the Society to do business.

163. During the 1993 audit conclusions in respect to new business were noted in the summary review memorandum. It was recorded that audit considered that the high level of new business growth attracted by the Society over the past few years would have resulted in some new business strain. However the auditors felt that the impact of the associated potential strain was mitigated by the fact that much of the Society's new business was recurrent single premium business, in respect of which no significant problems would arise. No comment was noted in respect of this topic in the following year.

164. New business strain returned as a factor in planning the 1995 audit. The auditors identified two 'critical success factors' regarding new business strain:

i. Monitoring the capital requirements of business growth so as to avoid undue financial strains, and

ii. Expanding the product bases to reduce dependency on pensions business.

However, there were no further comments. New business strain was not identified as a factor of importance in the following year.

165. In dealing with the 1997 audit, the auditors' financial SWOT analysis identified, among the Society's weakness, the fact that:

> "93% of ELAS's business relates to pension products, increasing the Society's vulnerability to changes in market trend and Government legislation and increased claims as more personal pensions mature."

Furthermore audit planning identified the pension maturity profile as an issue, which would be reviewed by analytical procedure:

> "Review future maturity profile products and compare to management forecasts and budget. Does the maturity profile reflect management predictions and investment profile."

166. In 1998, there was a rehearsal of the treatment of the new business loan. The mechanism was described as follows:

> "Loadings are attached to premiums received over the life of a policy, as initial premiums received at the start of a policy are insufficient to fund the expenses incurred in the first year. The shortfall is funded by a loan from the 'with-profits' policyholders. Interest is charged on this loan."

There was no further relevant comment.

Pension Transfers

167. Pension Transfers became a topic of interest in 1993. It was recorded that, at the year-end audit-closing meeting, the auditors raised the issue of 'pensions mis-selling (pensions transfer)' with management. Ranson had indicated that the exposure for the Society would be minimal and that accordingly he felt that no provision was necessary. While the valuation did not explicitly provide for such an exposure, there was, in his opinion, sufficient 'fat' in it to cover any exposures that

might arise. Ranson further explained to the auditors that even if there were large amounts of transfers carried out, the Society's exposure would be say 5% of £5 billion, which was not significant in the context of the accounts of the Society.

168. Professor Smith enquired of the auditors whether they had relied solely on Ranson's views in assessing the adequacy of the pensions mis-selling issue. The auditors responded that they had done sufficient audit work to satisfy themselves that no provision was currently needed. This conclusion had been drawn on the basis that the auditors believed that the Society accepted such business mainly on an execution-only basis, which was not where the risk lay. Audit additionally went on to say that, as non-experts, it was difficult to assess the level of any provision that might be required, especially considering the fact that no guidance had been issued by the Securities & Investments Board. Professor Smith accepted the auditors' approach adopted in this area.

169. The topic returned in the 1994 audit. It was recorded that at an internal audit planning meeting the following matters were raised:

i. Ranson had implicitly provided for £50m with respect to pensions transfers.

ii. The provision had been made by adjusting an assumed interest rate used in the liability valuation.

iii. The difficulty faced by audit in auditing this provision.

iv. All staff subordinate to Ranson were unfamiliar with the approach taken by him in this area and they had referred audit staff directly to Ranson in this regard.

v. Audit had met with Peter Wilmot to review the complaint file and to discuss any significant issues arising. No matters of concern were raised from this meeting.

170. Grenham of the actuarial audit team confirmed that the Society had strengthened their valuation basis in order to establish an implicit pension transfer provision of £50m. At the 1994 year-end Ranson continued to assert the view that the Society had no material exposure to the pensions transfer issue that was affecting the industry widely. Single premium business sold during 1987 to 1993 was £680m. Guidance issued by the Institute of Actuaries indicated that a provision of approximately 10-25% of 'at risk policies' should be made. The Society considered the value of such policies to be around £300m; however it had not made a specific provision for this, but rather had implicitly provided for this value in the technical reserves.

171. The inquiry review has not identified any key information on pension mis-selling between 1994 and 1998.

172. In the 1998 audit, the adequacy of the pensions compensation provision was resumed as an issue of disclosure. Ernst & Young had reviewed the Society's provision. The auditors said that, superficially, the provision looked prudent, and, if one considered the average Equitable case size, the provision looked reasonable. They noted that the £25m increase in the charge during the year was not explicitly shown, but could be calculated.

173. In their audit planning report to the audit committee for the 1999, Ernst & Young highlighted the pensions review among the key areas of focus for them during their audit. In respect of the 2000 audit the continued pensions review and other products review were again highlighted in the audit planning report to the audit committee.

2000 Audit

Closing Reports

174. There was a wide-ranging review of audit matters reflected in a series of documents that recorded aspects of audit work generally. The first of these that has to be noted refers to the rectification scheme; the scheme devised to provide compensation for those who might have been disadvantaged by the operation of the differential final bonus policy.

175. The actuarial audit summary review memorandum included comments on the GAR rectification scheme:

> "There is a technical provision of £210.9m in the long term business provision held in respect of the 60,000 GAR (guaranteed annuity rate benefit) holders who had retired prior to the House of Lords' ruling, having elected not to take the GAR. These cases are being reviewed to see who may have benefited from the ruling.
>
> Two groups of policyholders were identified for rectification, these being:
>
>> 1. The first group is policyholders who didn't take the open market option, who didn't take the GAR, but may have taken the GAR in the light of the House of Lords' ruling. The proportion of policyholders who are assumed to have decided retrospectively to take the GAR is correlated to the excess value of the GAR over the CAR.
>>
>> 2. The second group of policyholders are those who took an open market option, but who might have decided to take the GAR. Of these, 80% are assumed to make a case for rectification, for 80% of the benefit (assuming 20% taken as cash).
>
> The additional value of the benefit taken for each population is taken as 35%, based on recent additional costs. This is mitigated by an allowance of 0-5% for lower bonuses which would have applied.
>
> This approach appears to be reasonable, but will need to be updated to allow for actual experience as the scheme progresses. However, the assumption that 80% of the policyholders make a case for rectification is very much a guesstimate however if the correct percentage was 90% the difference would be of the order of £20m, which is within material limits, therefore we believe the assumptions are reasonable."

The team noted that they had reviewed policyholder literature and with-profits guides to check the statements made on surrender values.

Presentation of Results

176. There was a note on the Society's practice. It set out that the Society's results were presented in two formats, namely BR1 and BR2. These tracked through the movements in the reserves over the year:

> "BR1 This shows last year's result rolled forward allowing for premiums, claims (net of terminal bonus), unwinding of valuation interest rates and explicit allowance for lapses. This provides an estimated expected year-end reserve. ... This is compared with the result on the basis of the actual data at the end of 2000, using last years' assumptions. The differences are due to changes in the underlying data. The results show that the estimates are very close to the actual results.
>
> "BR2 This shows an estimated result, based on estimated rolled forward data, but using the new assumptions for the 2000 year-end. This is compared with the actual result on the new assumptions."

The note stated that the auditors had compared the end result on the old assumptions and the new assumptions, in order to check the reasonableness of the

movements. In order to do this, they had used high level reasoning based on annuity factors, and varied the interest rates and mortality assumptions. As a result of these checks, they were satisfied that the movements reflected the underlying change in assumptions.

177. In relation to deferred acquisition costs, it was noted that the accounting policy adopted historically was that for the recurrent single premium type of contract where a series of future premiums was expected, only a proportion of the acquisition costs in the year of sale was covered by the premium loading received in that year. The likely change in policyholder behaviour as a consequence of the decision of the Society to go into run-off, was that there would be a reduction in future premiums. It was necessary for decisions made regarding future premiums for the purposes of the provision to be logically consistent with the treatment of deferred acquisition costs. 'Group Actuarial' had processed an acceleration in the amortisation of deferred acquisition costs for paid-up policies which did not have a GAR. This change was made to reflect the expected increased rates of policy turnover as a result of stakeholder and the events impacting the Society in 2000. It was said that, in view of the assumptions about future contributions for GAR policies, it would be inappropriate to accelerate the amortisation of deferred acquisition costs in respect of those policies.

178. The continued use of implicit future profits items was discussed. The auditors had reviewed correspondence between the Headdon and FSA relating to the Society's application for a section 68 order for a future implicit profits item. The correspondence reviewed reveal that the Society had applied for the use of £1.1 billion in future profits and included a certificate from the appointed actuary in support of this application. The certificate stated that the future profits used in the calculations were "in excess of sums that may be required to meet claims recovery premiums payable under the treaty...".

179. An appendix contained supporting information on the future profits calculation, which disclosed a value of £3.3 billion, suggesting that the proposed use of £1.1 billion was easily supported by future profits. The auditors commented that the subsequent House of Lords' ruling would have had an impact on the future profits used in these initial calculations, and requested further information of the Society in this regard.

180. At a meeting held on 22 February 2001 with the actuarial audit team, Charles Thomson confirmed that the section 68 order for the use of implicit items was still in place and that Society would be using £1 billion in their FSA return. Thomson noted that the FSA had requested a specific sign-off from him on the issue, confirming that there was no double counting of future margins between the implicit items and the GAR reinsurance. Audit sought to corroborate this independently.

181. The Society had indicated that, whilst there was no regulatory requirement to do so, it would be prudent to take account of the effect of the House of Lords' judgment. Accordingly, Ruth Loseby of the Society's actuarial team had explored three alternative methods as follows:

i. Retrospective method = £1.8 billion (lower value of both methods used)

   a. Method 1: deduct from past profits the additional cost of GAR liabilities that would have been paid out had House of Lords' judgment applied. Plus reduce profits for reduction in final bonus included in rectification scheme if had applied during this period = £2,650m.

   b. Method 2: more prudent to reduce estimated future profit calculation by estimated future costs of GAR's following the House of Lords' judgment (£2.6 billion + £0.2 billion). Assume a 60% take-up on retirement and 90% of benefits taken in GAR form (considered very prudent) = £1,793m.

ii. Overriding limit PVFP = £2.5 billion

> In assessing margins in future premiums and reserves, account was made for the potential to double count for the reinsurance treaty. Also excludes double counting in relation to the reinsurance treaty.

The conclusion reached was that in all cases the use of £1.1 billion at 31 December 2000 was justified. Consequently £1.0 billion was used in form 9 of the regulatory return.

Subordinated Debt

182. With regard to recent developments, namely the closure of the Society to new business and its then intent to sell to Halifax, the auditors reviewed the subordinated debt offering circular, to assess whether these developments had triggered any collateralisation events (ie need to repay principal capital and any outstanding interest). Audit stated that, given the current low solvency margin of the Society, the Board should consider the implications of insolvency on the existing subordinated debt.

183. As disclosed in the notes to the accounts, ELF plc, which was a wholly owned subsidiary of the Society, had issued £350m of subordinated bonds, the proceeds of which were lent on to the Society. The Society also acted as guarantor of the bonds. The offering circular for the bonds stated that if the Society transferred all or "a substantial part" of its long term business to another body, it must ensure that the whole of the share capital of ELF plc and all the liabilities and obligations of the Society relating to the guarantee were also transferred. A "substantial part" was defined as any part that, as at the most recent valuation date, represented 50% or more of mathematical reserves relating to policies entitled to share in the surplus of the Society.

184. It was recorded that management did not believe that the proposed transaction with Halifax triggered the requirement to make the transfer of the obligations under the ELF plc scheme. Ernst & Young stated that they concurred with this view on the basis that, under the proposed deal, the Society would not transfer the majority of its existing long-term business (ie the closed fund) to Halifax. They had reviewed the loan covenants in view of the current financial position of the Society and had not identified any breaches of the covenants.

Financial Reinsurance

185. On 2 February 2001, Alan Pielage of the Society wrote to Bannon informing him of two matters relating to the GAR reinsurance treaty:

i. The contractual terms regarding take-up rates had changed from 25% to 60%, and

ii. The treaty would be terminated when the Society duly changed its bonus practice regarding GAR's in response to the House of Lords' judgment.

186. The audit actuarial summary review memorandum (based on information received by audit from the Society during February 2001) contained the following final assessment of the reinsurance treaty and its financial implications:

> "A reinsurance treaty is in place to mitigate the impact of the GAD reserving basis on the FSA returns. The reinsurer is Irish European Reinsurance Company Limited.
>
> Under the terms of the reinsurance, if the value of the benefit paid out during a year through the GAR being exercised is more than 60% of the total value of benefit paid out, the reinsurer meets the additional cost. The benefit being valued for this purpose is the basic sum assured plus attaching bonuses.
>
> A recovery premium is then due from the reinsured to the reinsurer equal to a proportion of the terminal bonus cushion, where the proportion is determined as the excess of the take up rate over 60%.

In practice, a delay is applied to the payment of the recovery premium to the reinsurer.

An annual premium is paid to the reinsurer of £700,000 p.a., increasing with Retail Price Inflation on an annual basis. This was increased from the £625,000 payable in the previous year, to reflect the increase in the assumed take up rate to 60% from 25%, following the House of Lords' ruling.

Correspondence with GAD mentions that while the reinsurance arrangement previously in place remained, the net basis would remain broadly unchanged. A subsequent letter (9th January 2001) indicates that GAD are expecting ELAS to review their assumption following the House of Lords' decision. There is no specific mention of the 60% reinsurance treaty."

187. In an audit file note dated 6 March 2001, the technical aspects of the accounting treatment of the reinsurance contract were discussed. The ABI SORP (S194) requirements relating to financial reinsurance were dealt with, and audit concluded that they were not keen to apply this method, as they believed the recognition of future margins was imprudent.

188. On 12 March 2001 Bannon contacted Ruth Loseby of the Society and asked if there was any correspondence with the FSA regarding the GAR reinsurance treaty. Loseby responded by saying there wasn't; however the treaty had been in force for over 2 years and the FSA had not challenged it. She went on to add that the FSA were heavily involved through the period when the reinsurance was being negotiated. Bannon informed Gregor Stewart of this, who said he would raise the point at the forthcoming audit committee meeting to be held on 14 March 2001.

189. The auditors' findings and treatment of this reinsurance contract were communicated to the Board as follows:

"At 31 December 1999 the Society had entered into a reinsurance contract with Irish European Reinsurance Company Limited. This contract had been the subject of considerable commentary primarily because it lapsed following the House of Lords' ruling. The contract had no impact on the 1999 Companies Act Accounts but did give relief in arriving at the GAR provisions established for the purposes of calculating the solvency reported to the FSA.

In 2000 the calculation of the GAR provision in the FSA return assumed a take-up rate of 90% on the basis of guidance issued by the Government Actuaries Department. The gross provision was then reduced to take account of a revised reinsurance contract under which Irish European Reinsurance Company Limited would initially meet the cost of GAR take-up in excess of 60%. The impact of this reinsurance in the FSA return was to reduce the liability by approximately £900m.

An important feature of the reinsurance treaty was that the cover it provided ceased on the insolvency of the Society.

No recognition had been made of the reinsurance contract in the Companies Act Accounts. The level of take-up assumed for the purposes of the GAR provision in the accounts was at the point where the revised reinsurance contract became effective.

Given that the solvency of the Society was very low at the year-end the continuing provision of reinsurance cover was of concern. However, since the treaty did not define "insolvency", the Appointed Actuary had assumed that this meant Companies Act rather than FSA regulated solvency.

Notwithstanding current solvency cover, the directors should understand the implications of solvency on the reinsurance contract and ensure that this position was continuously monitored."

Regulatory Return for 2000

190. A meeting was held between Ernst & Young and the Society on 29 June 2001 to discuss the 31 December 2000 regulatory return. Attendees at this meeting were: Peter Nowell, Charles Bellringer, Paul McNamara, Rob Holman, Gregor Stewart, and Angus Millar. Ernst & Young had called the meeting to discuss:

i. The Society's letter to Martin Roberts of FSA, dated 28 June 2001 about the Society's position;

ii. An additional paragraph to the appointed actuary's certificate on the FSA return;

iii. Any consequential impact on the audit opinion on the returns; and

iv. The duty of Ernst & Young to report to FSA under SAS 620.

191. Bellringer confirmed that the Society had sent a letter to the FSA on 28 June and he outlined the events leading up to the submission of the letter:

i. There had been no bonus declaration at 2000 year-end;

ii. Contractual claims continued to receive an 8% interim bonus;

iii. The decline in equity values in first part of 2001; and

iv. There had been a higher level than average of contractual claims.

All these events had exacerbated the Society's weak solvency position.

192. The Board met on Wednesday 27 June but failed to reach any conclusion on what action to take to improve the solvency position. Hence the chief executive had felt it necessary to send a letter to FSA to that effect prior to the filing of the returns. For the same reason the appointed actuary had added a paragraph in the return, the wording of which was accepted by FSA.

193. Nowell explained that claims were running at £1.1 billion per quarter, many of these being contractual and for that reason were not subject to the market value adjuster (MVA). Thus policyholders were receiving claims well in excess of their asset share. He stated that, in terms of actuarial guidance PN 8, he must not set mathematical reserves at a level which might lead directors to declare too high a bonus rate. At year end the excess of policy values over available assets had been 10% (which was in Nowell's opinion about the maximum that should exist). The excess had grown to 18%. Nowell agreed that such an excess was likely to result from smoothing but that, after 6 months, action should be taken. From the 10% level of excess, policy values had increased 4% (interim bonuses for 6 months) while £500m had been received from Halifax, bringing the excess to 18%]. Nowell felt that a measure similar to an MVA was necessary for contractual claims and that reducing interim bonus rates to nil would achieve this. He considered the current bonus policy to be unsustainable. In the absence of any appropriate Board action he felt obliged to set aside specific reserves for some part of future terminal bonus. On that basis, at the current date, the Society's form 9 position would be in deficit. However Nowell and Bellringer confirmed that the Board would take appropriate action to provide a positive solvency position. It was expected that the Board meeting of 2 July would address this issue. McNamara and Holman stated that, for the same reasons that the appointed actuary had to report to FSA, audit had to do this under SAS 620.

194. An internal follow up meeting held by Ernst & Young on the 2 July 2001 with respect to the completion of Society's FSA returns was attended by Holman, McNamara, Stewart and Millar of Ernst & Young and also by a solicitor advising Ernst & Young. Following on from Ernst & Young's meeting with the Society on 29 June 2001, the following issues arose:

i. Whether Ernst & Young had a duty to report to the regulators under SAS 620 and the various provisions of the Insurance Companies Act 1982, and

ii. What they should be saying in their regulatory return audit report.

The factual context identified was that policy values were in excess of asset shares and the Board did not have an appropriate policy position to deal with this. The appointed actuary therefore considered it necessary to reserve for two years' terminal bonus at 30 June 2001, which would render the Society insolvent in regulatory terms. The appointed actuary was to modify the standard certification in the regulatory return. However the appointed actuary felt that the Board would support a policy change. In the event, the full facts were set out in the appointed actuary's report, and the audit report was left unchanged. Audit reported in terms of SAS 620. While the audit certification (dated 27 June 2001) in the regulatory return was not qualified, it dealt with the fundamental uncertainty.

2000 Audit Conclusion

195. The audit file contained the following conclusion in support of the audit opinion given in respect of the 31 December 2000 accounts:

> "On the basis of our work performed to date, we anticipate issuing an unqualified auditors' report in respect of the statutory accounts. However, as a result of significant uncertainty regarding policyholders' behaviour in the future with regard to GARs the notes to the accounts refer to a fundamental uncertainty in estimating the GAR provision and we have included a fundamental uncertainty paragraph in our audit opinion..."

196. McNamara, prepared the following file note in support of the conclusions reached by the audit team:

> "In arriving at the technical provisions in the balance sheet of the Society for the year ended 31 December 2000, it has been necessary to increase the technical provisions for amounts payable to policyholders by approximately £1.6 billion in respect of the obligations for the guarantee annuity rate options. This increase follows the decision in the House of Lords, which in effect has made the taking of the guaranteed annuity rate option far more attractive for policyholders.
>
> In arriving at the provision there are four factors, which are crucially important in its computation. Two factors – interest rates and mortality – are reasonably straightforward in so far as they are assumptions that have to be made in other parts of actuarial valuation and therefore are based on current experience of mortality or interest rates. The third factor relates to the extent to which policyholders will continue to make contributions. We have looked at the underlying assumptions and whilst there is the possibility that GAR policyholders will be more enthusiastic about investing in the future, they are a discrete and declining group, and there is a reasonable basis for believing that the assumptions made about the levels of future contributions are realistic and indeed may be prudent. They have certainly been strengthened since last year.
>
> The fourth assumption gives rise to greater difficulty. Based on the decision in the High Court and the Court of Appeal, there was the belief that the guaranteed annuity rate option was not generally speaking attractive to policyholders and experience had shown that there was a very low level of take-up of the order of 1 – 2% which led to the disclosure of £50 million being the best estimate of the cost. However following the House of Lords' decision in July 2000, the take-up experience by policyholders has been substantially greater. We are currently checking the figures but the experience in the September to November period was approximately a 53% take-up. The experience in December was 57%.

The draft technical provisions have assumed a take-up rate of 60% and we are awaiting the January take-up rate to be advised to us. Clearly at 60% there is not much headroom over the experience in the last four months, and there has to be a belief that the experience in that period may well not be representative of what will happen in the future. A key element of reducing the exposure is that most policyholders wish to exercise the right to take the 25% cash lump sum out of their accumulated fund, and therefore the take-up rate immediately drops to 75%. Actual experience shows that the cash lump sum exercise is approximately 22.5% so the ceiling on the take-up rate is 77.5%.

Since October/November the Society has been offering policyholders the right to split the fund such that part of the fund can be applied at a single level annuity and the balance of the fund can be applied to buy a joint survivor annuity. The experience of take-up of the joint survivor annuity in November and December was very low and far below what we would have been expecting. It is possible that all the uncertainty surrounding the law case has kept policyholders back from exercising their annuity rate option such that in recent months there has been pent up demand, which will now abate, and there will be a more normal level of exercise. However this remains speculative and is clearly not supported by historic evidence. The take-up rate also in the September/December period was driven down by the propensity of some policyholders to flee the Society including GAR policyholders, which certainly had a benefit.

The Halifax deal may temper the propensity of policyholders to flee and indeed there is already some indication that, whereas surrenders were running at about four times normal prior to the Halifax deal, they are now down to about twice normal. If the propensity to flee is reduced it could drive up the take-up rate further. There is no point looking at February experience as, following the Halifax deal and the suggestion that there will be a Scheme of Arrangement, there is an in-built bias now for policyholders who want to take the GAR option to exercise the option rather than wait for the Scheme of Arrangement. Furthermore those policyholders for whom the option is unattractive will be far more attracted by a possibility of their policy benefits being enhanced in the future by 20%.

In the actuarial work performed by Tim Roff's group the reports given by us stressed that the take-up rate estimates were entirely those of the Society as at that time there was no experience of what the take-up would be.

Based on discussion with Peter Standish, as the Independent Partner, and looking at the financial statements, I have drafted a Fundamental Uncertainty note which is attached and I also attach the first draft of the footnote for inclusion in the Annual Report & Accounts to which it refers. The sensitivity of the movement is such that if the take-up rate is at 60%, which has been used in the accounts, rose to 70%, there will be an increase of £300 million in the technical provisions. This approximates to 1% of the technical provisions on that basis would be seen as immaterial. However, the corresponding entry would be a reduction of £300 million in the fund for future appropriations of £2.5 billion. In so far as the FFA in effect covers the terminal bonuses, such an adjustment might be seen by the more astute to indicate that the Society should increase the market value adjustment to policyholders surrendering early from 10% to a higher figure and they might be tempted therefore to run before the MVA gets adjusted.

There is an additional complication. As has been widely reported in the press the Society entered into a reinsurance contract in 1999, which lapsed following the House of Lords' decision. A new contract has been entered into which in effect gives benefit if the take-up rate exceeds 60%. However, the reinsurance contract is a form of finite reinsurance for which there will

inevitably be some pay back out of future margins. I am not an enthusiastic for giving any recognition to financial reinsurance contract in the Companies Act accounts whatsoever. We did not do so in 1999 which following all the controversy that has arisen is just as well. It is also true that if the take-up rate falls to 50%, which was really the initial estimate of the company, then the Technical Provisions are overstated by the corresponding £300 million, which would benefit the Fund for Future Appropriations, and indeed various other aspects of FSA solvency.

There is a further aspect to this. If in due course the Scheme of Arrangement is adopted whereby the GAR policyholders give up their GAR option rights for a mixture of enhancement to their reversionary bonuses and their terminal bonuses, then this problem in effect falls away. However the details of the Scheme of Arrangement are embryonic at the present time and there is of course no certainty or even indication of certainty that the relevant classes of policyholders will support whatever proposition is put in front of them."

Comment

197. As stated at the outset, the narrative in this chapter has proceeded substantially without comment. I have taken comfort from the auditors' findings in arriving at factual conclusions in earlier chapters, and to a lesser extent have relied on material from this summary in later parts of this report.

PART V: POLICYHOLDERS' REASONABLE EXPECTATIONS

CHAPTER 13: ORIGIN AND INTERPRETATION OF P.R.E.

1. In previous chapters, I have examined the Society's financial statements and the position presented in statements based on, or adjusted for, the office valuation of liabilities. The office valuation included full recognition of accrued final bonus values. In general there was no explicit or implicit reserve or provision for future terminal bonus payments in either the regulatory returns or the statutory accounts (with the exception of 1979 when an explicit advance provision of £6m was made for terminal bonus payments over the following triennium). The provision for accrued terminal bonus in the office valuation produced results in which aggregate policy values exceeded available assets by varying margins. The over-distribution implicit in this excess was calculated throughout the period 1989 to 2000, and began at latest in 1987. The financial implications of the bonus allocation policy, in aggregate, were not made known to policyholders, though each received intimation of the rolled-up policy value applicable to his or her policies in and after 1989.

2. I have set out my conclusions, and the basis for those conclusions, that there was no obligation to set up mathematical reserves in the regulatory statements, or to make technical provision in the Companies Act accounts for accrued terminal or final bonus. There are technical issues whether the part of the final bonus that could reasonably have been expected to be paid on claims arising before the Society could, in any practical way, alter its published rates should have been provided for in the Companies Act accounts as current liabilities. The first quarter's payments were credited on the basis of the bonus declaration from February in the previous year, and by the date of signing off of the accounts would have been credited in whole or in part. The theory that the Board could at any time instantaneously reduce final bonus to zero had no realistic application to such sums. And it could have been argued that the same applied to the following year's payments. But in this part of the report the focus is on benefits that the policyholder might reasonably have expected to receive at a future date for which no liability provision would have been made, and in particular the excess of accrued final bonus over such part as might reasonably have been accrued as a current liability.

3. In accounting terms, sums to cover such accrued final bonus would have been held in the investment reserve, or fund for future appropriations after 1994, in the case of the Companies Act accounts, and would have formed part of the excess of assets over mathematical reserves and other financial requirements in the case of the regulatory returns. Over the period of greatest concern, the 1980s and 1990s, it was the practice of some life offices, as a matter of prudence, to maintain sums deemed sufficient to meet policyholders' reasonable expectations as to future terminal bonus payments in investment reserve or fund for future appropriations, in the form of general reserves. Equitable followed that practice until about 1986 or 1987, but thereafter did not maintain such a balance as a matter of policy. As a matter of Companies Act accounting they were not required to do so by any accounting standard or guidance. The Society was not required to demonstrate its capacity to maintain payment of final bonus for regulatory purposes, and was not threatened with regulatory intervention on account of its failure to do so.

4. Liability to intervention is a basic risk of business in a regulated environment. Given the jeopardy that could result from intervention, it is a reasonable requirement of prudent conduct of business that management should avoid action or omission that might reasonably be expected to provoke regulatory action. In the case of a life office, it has been a ground for intervention since 1973 that the office may be unable to fulfil the reasonable expectations of its long-term policyholders or potential policyholders. If policyholders have been led reasonably to expect, for example, that terminal bonus payments will be made, or will be made subject to external market conditions, then the office might reasonably be expected to take

action to avoid the risk of disappointing those expectations, taking account as necessary of its current view of future market conditions. The question that arises is how the risk of regulatory intervention could be discounted if adequate resources were not held to meet policyholders' reasonable expectations of future final bonus. How could the risk of intervention on PRE grounds be eliminated or disregarded? To answer that, it is necessary to look at the history of the statutory provisions, their treatment by the actuarial profession, and their treatment by regulators.

5. I consider that it would be inappropriate to reduce the discussion to terms of 'asset share' or any other technical actuarial expression. It will be necessary to return to the development of asset share as a measure of policyholders' reasonable expectations by the actuarial profession. Like other actuarial expressions, 'asset share' originally lacked, and may still lack, an agreed meaning, and individual actuaries have been free to develop their own policies and practices in formulating and applying asset share techniques. However, a with-profits policyholder's asset share generally must relate, in some way and to some degree, to the assets representing the with-profits fund. Typically it is reflected in two components of value: accumulated contractual or guaranteed benefits and the emerging final adjustment commonly called final or terminal bonus. But within those general propositions there is wide scope for variation.

6. In the case of a mutual such as Equitable, there is scope for differences of interest as among different cohorts of contemporary policyholders, and for inter-generational differences. Aggregate asset shares of current with-profits policyholders may not equal with-profits assets because the Society maintains an inherited estate, as Equitable did in the early years of the period studied. Asset shares in that case may be defined in terms of the policyholder's contributions and the earnings on them during his period of membership of the fund. Differences among contemporary cohorts of policyholders may arise from variations in the provisions of their contracts. Subject to these differences, the assertion that a policyholder has a reasonable expectation of realising asset share implies at least a contingent right to the whole accrued contractual benefits plus a share of the excess over those benefits represented by an allocation of the aggregate or some part of the aggregate of the office's with-profits assets over guaranteed benefits. If the whole aggregate excess is not reckonable, there will inevitably be a balance of with-profits assets in the form of an estate of some definition.

7. In the case of proprietary offices the interests of shareholders and policyholders require definition and balance. In the early 1990s, some proprietary companies attempted to secure the release of funds to shareholders on the view that what had not been distributed in the exercise of discretionary powers belonged to shareholders. Regulators responded by asserting the policyholders' interest in undistributed balances on grounds of PRE. Asset share in those cases may have reflected the result of the processes of analysis and discussion, and may have provided language for a description of that result. It did not provide a consistent and objective set of criteria for determining individual and aggregate policyholder interests. However, again, the result of the process of determining the policyholders' asset shares at any given time would be reflected in the sum of the value of contractual and guaranteed benefits on the one hand and non-guaranteed terminal or final benefits on the other.

8. Across the with-profits field, assets share appears, at least until recently, to have represented the result of processes of identification of policyholders' interests rather than to provide a methodology for determining those interests in the first place. However, whether that is correct or not, in order to reflect reality asset share would require recognition of the policyholder's contingent right to participate in the part of the aggregate asset value that was not reflected in the mathematical reserves or technical provisions of the with-profits fund. Without recognition in some form of that contingent interest the policyholder's only reasonable expectation would be to receive a windfall at maturity on top of accumulated guaranteed benefits from a fund in which no-one had any measurable interest prior to the contractual event.

The non-guaranteed element of asset share, which is inevitably to some extent a function of investment experience over the duration of the policy, would have had no value immediately before and full value immediately on the occurrence of the contractual event. In order to assess this, and the other issues that arise in the present context, it is necessary in the first place to discuss the origins of the regulatory powers of intervention of grounds related to policyholders' reasonable expectations, and to form a view on the scope of those powers.

Insurance Companies Act 1973

9. The prospect of failure to meet the 'reasonable expectations' of policyholders and potential policyholders was introduced as a trigger for regulatory action in the Insurance Companies Amendment Act 1973 sections 12 (1) and 21. The expression was not defined by Parliament. The origins of and inspiration for the provisions appear to have become shrouded in myth, which must be dispelled if there is to be a reliable assessment of the regulators' approach to PRE. But first it is necessary to set the 1973 legislation in its proper context.

10. Discussion of future amendments to primary legislation and regulation began soon after the 1967 Act came into force and the 1968 regulations were completed. This discussion took place against the background of the Vehicle and General (V&G) case, which was under investigation, and other industry problems. The work of Sir Hilary Scott's Committee on property bonds and equity-linked life assurance was in progress. An early attempt to see whether the Life Offices Association might undertake a self-regulatory role was rebuffed, after which discussion proceeded on the basis of continued regulation by DTI and GAD.

11. Some of that discussion focussed on the respective roles of auditors and actuaries in the valuation of insurance liabilities and has already been referred to in chapter 11. Recent failures had highlighted the ineffectiveness of audit in general insurance. The actuaries' professional bodies and the industry were inclined to argue against the ability of the audit profession to audit the liabilities of life offices, and for reliance on the certification of appointed actuaries and 'actuarial auditing by GAD'. They argued for change in the regulations to exclude long-term liabilities from the standard audit 'true and fair' test under the Companies Acts.

12. Bound up with that was a debate on the basis of valuation for long-term business. Although DTI initially proposed a requirement only that the basis for valuing long-term liabilities should not be weaker than net premiums, this was quickly overtaken in discussion by a more robust requirement, based on proposals from the actuarial profession and the Life Offices Association[1], that valuation should be on an 'adequacy' basis. The profession highlighted the inadequacy of a 'solvency' valuation based on gross premium valuation, on which basis solvency would "in almost all cases be comfortably demonstrated" and was "inadequate to protect the interests of long-term policyholders".

13. Although there was some hesitation within DTI about the proposal to relax the true and fair standard in relation to liabilities (for fear that an alternative standard would obscure the position for policyholders and the public by enabling general insurance companies in particular to 'equalise' underwriting failures across years), proposals for principles of an 'acknowledged standard of adequacy' were developed. As in the demutualisation debate that was to follow 20 years later, the focus of much of this debate in the context of long-term business was ensuring that valuations were not inflated so as to benefit shareholders at the expense of policyholders. (The proposals that went into the Bill also included a provision requiring life offices to declare the proportions of surplus that were, by custom, allocated to policyholders and shareholders. The intention was not to constrain

[1] Whose principal spokesman was Ronald Skerman, of whom more below.

offices from increasing the proportion of surplus paid to shareholders, but to ensure that the resulting publicity would impact on their prospects for new business.)

14. The GAD view on these issues, put forward by the then head of their insurance directorate, Colin Stewart, is particularly significant for the issues I have to consider in this report. GAD's view was that the determination of surplus, and its distribution between policyholders, was at the discretion of the directors. For this they required the advice of the actuary. An audit report that a discretionary figure for the amount in the life fund was true and fair would serve no purpose. Auditors were not equipped to comment critically on the work of an actuary, as the V&G case had demonstrated in relation to non-life business, but GAD were so equipped.

15. GAD took forward the work to reduce the profession's adequacy principle of valuation to language that would be appropriate for legislative purposes. The exercise went through several editions and involved extensive consultation. The debate anticipated the issue of reserving for future bonus. There was general agreement among industry and professional bodies, but the proposals were not uncontroversial. The Bar Council in June 1972 disagreed with the DTI's proposal that the valuation should take into account expectations of future bonuses, arguing that risk was inherent in with-profits, and that policyholders should not be preferred over other creditors of the life office. The GAD view, as expressed by Stewart in response to the Bar Council's objection, was that the adequacy valuation should <u>not</u> become a method by which the right to future profits was capitalised and treated as a liability. However, the concept that the reasonable expectation of policyholders should be capitalised in the adequacy valuation persisted as the principles were developed.

<u>Intervention powers</u>

16. A prime motivation for new legislation concerned the ineffectiveness of existing powers of intervention, as demonstrated by recent cases, a problem laid at the door of hasty drafting of the 1967 provisions. In an internal paper prepared for the Secretary of State to send to other senior Ministers in December 1972 the argument for the Bill was made in the following terms:

> "The point is this. The Bill will reformulate the Department's powers of intervention in the management of insurance companies whose viability is suspect. Since 1967, when these powers to intervene with a view to averting insolvency were hastily grafted on to the earlier power to petition for winding up when insolvency had occurred, it has been found that their form is too rigid and restrictive to permit a proper choice of action to remedy or minimise the risk in the wide variety of circumstances in which it may arise."

17. The paper continued with a statement about the public expectations of regulation that resonates in the present context, and which reflected an active debate within the department about the practicalities of regulation:

> "Clearly there can be no guarantee that the Department will invariably identify a risk in time and apply a successful remedy, but this is precisely what the public expect of us – a combination of prescience and omnipotence. I would like to come as nearly as possible towards satisfying this ideal and for this purpose I consider more flexible powers essential."

The proposal was for two kinds of power:

> "First, there will be a range of possible powers of intervention, which will be exercisable either in particular, readily foreseeable, situations or whenever I consider them necessary for protecting policy-holders from the risk of insolvency. Second, there will be a 'safety-net' power enabling me to impose any other requirement that I think necessary in any situation where the interests of policy-holders require it."

18. Thus it was proposed that there should be a catch-all trigger to be relied on in circumstances which had not been anticipated in the framing of the more specific

powers for intervention. The concept of policyholders' reasonable expectations was to form part of the trigger for both kinds of intervention.

19. It has been suggested to the inquiry that the legislation picked up an existing actuarial principle with reference to policyholders' reasonable expectations. Stewart in particular directed the inquiry to a 1966 paper by Ronald Skerman (see below). In the departmental records recovered there was no reference to Skerman's paper as inspiration for the principle. Whatever its antecedents, the earliest reference to it as a possible regulatory test the inquiry has identified is a DTI memo dated 3 November 1971 in which Cyril Homewood[2] used a draft clause for insertion into the Companies Act 1967 as "the most convenient means of demonstrating the possibilities...notwithstanding the lawyers' objections to lay competition". He proposed at that stage that the powers of intervention could be exercised:

> "If in the opinion of the Secretary of State there is a risk of an insurance company becoming insolvent or of the reasonable expectations of its long term policy holders being prejudiced."

20. The immediate reaction of Stewart at GAD was that there could be considerable practical difficulty in operating such a broadly-framed trigger:

> "This gives a very wide discretion and would, it seems to me, be likely to lead to a large measure of controversy if it were to be invoked other than rarely. It would certainly mean that the scrutiny procedure carried out in GAD would be very different in nature; would we not have to address ourselves to advising you, in the case of every company, whether or not the reasonable expectations of the long-term policyholders were being prejudiced? It would be a much bigger job for us, invoking [*sic*] a very thorough examination of a company's affairs – very thorough indeed – to determine what we would regard as a 'reasonable' expectation for the policyholders in general, and for particular groups of policyholders."

21. There was no suggestion that such a provision would be difficult to understand or interpret, the issue was one of capacity and resource. The issue of resources for DTI and GAD had also been raised by the actuarial profession in the course of the discussions, and the need for additional manpower was in due course acknowledged by DTI.

22. The centrality of the concept of reasonable expectations, consistent with the thinking on the adequacy standard, was reflected in the instructions that went to Parliamentary Counsel. It was made clear that the references to "expected" benefits extended beyond contractual benefits, and therefore that protecting policyholders' interests in future bonuses was to be a central regulatory function for which Ministers would be answerable to Parliament. In commenting on the instructions in draft Homewood also confirmed that the intention was that "present and future policyholders' interests come into consideration". The departmental solicitor instructing drafting counsel also advised DTI officials that, while counsel should be allowed to devise his own general formula, the drafting was partly a matter of policy and officials must be prepared to put their ideas on drafting forward. Thus objections to the lay competition were not raised and Homewood's formulation was advanced in the instructions. There is little room for doubt, if any, that in taking up the solicitor's advice, and effectively proposing a draft clause, Homewood reflected DTI's policy objectives of securing wide powers of intervention.

23. It was also clear from the advice offered to Ministers that it was a deliberate feature of the proposals that the trigger should be resistant to narrow legal interpretation that might be adopted, by the regulators or the regulated, to curb their use. This approach was endorsed by Ministers, who took the view that once the principle that policyholders required protection was accepted, it was then necessary to ensure that problems could be speedily addressed. Political concern centred not

[2] See also chapter 11, paragraph 21.

so much on whether the powers should be strengthened, Ministers were clear that they should, but on the prospects that intervention might lead, or be seen to lead, to the department taking over responsibility for running insurance companies, and thus lead to "backdoor nationalisation".

24. However, there continued to be some concern among the officials in DTI responsible for its design that the 'catch-all' intervention power might be too broad. The dangers were rehearsed in the memorandum that was prepared for the Secretary of State to send to the Home Secretary and the Lord President in December 1972. It identified 2 dangers:

> "first, the greater the discretionary power we have, the more we shall be criticised with hindsight when the inevitable failure occurs. Second, there are bound to be objections to giving the Department very wide powers to impose on insurance management requirements of a kind not foreseen by Parliament. The difficulty with this last is of course that we need the wide power precisely because we cannot foresee all the permutations of risk and remedy with which we can expect to be faced."

The issue of backdoor nationalisation was acknowledged, though the likelihood was seen as remote. But the essential argument was that:

> "Unless we are to go back to the non-interventionist role assigned to the Department before 1967, I believe that we must go forward in this way".

25. The concern within DTI, which had been raised by Homewood's superior, Philip Brown, on 29 November had been that such a 'catch-all' intervention power carried with the danger:

> "... that we shall have virtually no public excuse if any company becomes insolvent for any reason whatsoever - if one has virtually unlimited powers, one is expected to use them."

Brown recognised that a broad test implied broad responsibilities and that these might be difficult to meet in practice without considerable extra regulatory input.

26. However, Brown's own superior, Tony Peck[3] was more sanguine than his subordinate. He sent a minute to the permanent secretary on 1 December 1972 that sought to allay these concerns. He pointed out that Ministers had accepted, on the basis of a paper circulated across Government in September, that "no system we could contemplate would eliminate the occasional failure or give absolute protection" and that the aim was to give policyholders "a reasonable measure of protection". Significantly the paper had confirmed that the basic method for achieving this was to be the examination of detailed returns to be required of offices, with intervention if this examination gave cause for alarm. Any other method was thought to involve too great a degree of control over management decisions. It had also been acknowledged, and accepted, that more staff would be needed "to do the job properly", and these would be made available "as soon as they could be mobilised". Peck also cited the alternative risk of criticism if a situation arose that could not be dealt with because it had not been anticipated in the Bill. This last point was used from that point to reinforce the case for wide powers.

27. In a note from his private office on 18 December, the Parliamentary Under Secretary of State, Lord Limerick, acknowledged Brown's points, but agreed with Peck. His view was reported:

> "I find I can reaffirm our present line with equanimity. Basically this is because the alternatives we discussed appear to be either less effective (eg omitting the "catch-all" provision) or less acceptable philosophically."

28. It is clear from the exchanges (of which a few only have been cited) throughout 1972 that the powers of intervention were not thought to be solely an aspect of the

[3] Who was a 'deputy secretary', later called a 'grade 2', the grade below permanent secretary.

valuation method, with the developing notions of an adequacy standard, or restricted to purely actuarial considerations in any way. The clarification that the practical ground rules had been discussed by and agreed with Ministers, and that the scrutiny would continue to be based on the regulatory returns, appears to have met GAD's concerns about the administrative burden implied by a comprehensive consideration of policyholders' reasonable expectations. On 6 December Stewart wrote again to DTI, this time expressing the opposite concern from previously. He was now concerned that in light of the comments made by Brown the grounds for intervention might be cut down, "emasculated" even. He contended that wide grounds were necessary to ensure that the powers might be exercised "without undue formality". Indeed, perhaps it was time to stop "pussy-footing around", he suggested, and bring in a requirement for annual actuarial valuations.

29. The case for wide discretionary powers was discussed and agreed at an inter-departmental meeting on 13 December and by a Cabinet sub-committee on 17 January, the likely reaction of the House of Lords was assessed, and the concept of reasonable expectations was duly introduced in the Bill. Initially the provision was drafted in terms of the Secretary of State considering it 'expedient' to exercise the powers in order that the reasonable expectations of long-term policyholders might be fulfilled, though this was amended in committee to say that the powers could be exercised where the Secretary of State considered it 'desirable' to do so. Reference to potential policyholders was also added.

30. The notes on clauses explained that the powers would only be exercised "where it was obvious that the reasonable expectations of policyholders were not going to be fulfilled", and that this would "stop well short of seeking to ensure that with profits policyholders received 'value for money' under their contracts or a particular level of bonus ... regardless of the amount of surplus revealed by the periodic actuarial investigation". It has been suggested to the inquiry in the course of maxwellisation that such references indicate that a passive approach to the monitoring of PRE was what Parliament clearly intended. However, Ministers made clear in debate the intention that the test should go beyond the contractual rights of with-profits policyholders, and that it should reflect their entitlement to participate in profits.

31. The Life Offices Association expressed concern at the scope of the powers when given advance information on the Bill at a meeting on 14 December, and there was some fierce opposition to the proposals in Parliament, much of it focussing on the introduction of a 'fit and proper person' test as well as the intervention clauses already referred to. There was some criticism of the breadth of the intervention powers, although this did not feature prominently in submissions made by the industry. The significant point to make about these debates is that the argument for the provisions did not alter. The intention was clearly stated as being about strengthening regulation in response to recent events, making the intervention powers more effective, and about looking after the interests of policyholders. This is hard to reconcile with a view that the regulatory role was essentially unaltered.

32. It was acknowledged that the powers sought, and obtained, were wide, and that specific instances of their likely application could not be anticipated with any degree of certainty. The powers had to have the flexibility required to enable regulators to respond to the unexpected. It was expected that it would take some years for the system to settle down and for policies on intervention to emerge from evolving experience. But essentially the powers were conceived as required to provide regulators with a sound method of achieving the regulatory objective of providing a reasonable measure of protection for policyholders.

<u>Origin of PRE as a technical actuarial term</u>

33. Before turning to the provisions it is necessary to take account of some evidence that 'policyholders' reasonable expectations' had a technical meaning in life assurance practice before the 1973 Act.

34. As mentioned above, Stewart told the inquiry that the expression 'policyholders' reasonable expectations' first appeared in Ronald Skerman's paper *A Solvency Standard for Life Assurance Business* published in the *Journal* in 1966. In that paper, Skerman discussed problems associated with the identification of relevant issues in liability valuation. His reference to policyholders' reasonable expectations came in his discussion of the essential characteristics of with-profits business and of his five principles of valuation. The paper set out certain fundamentals of insurance business:

> "The essence of the financial operations of a life office is that it receives premiums, interest and other items of income and undertakes liabilities to pay claims, expenses and other items of outgo. There is no means of ensuring with absolute certainty that it will be able to meet its liabilities – it is inevitably vulnerable to extremely adverse mortality experience and financial conditions. All that can be hoped for is a solvency standard which will ensure that it has every reasonable prospect of fulfilling its obligations."

35. The paper identified three problems, of which the third was:

> "Participation in profits. Holders of with-profit policies have taken them out in the expectation that they will benefit from a share of profits from time to time. Although an office is not under a contractual obligation which can be quantified in relation to the benefits which its policyholders will derive from future profits, it would be unsatisfactory not to take some account of the policyholders' reasonable expectations when determining the value of the liabilities."

Skerman identified the expectation that concerned him: the expectation of benefit from profits arising from time to time. He thought that the valuing actuary should have regard to the reasonable expectations as to participation in future profits in selecting the method used in determining the value of liabilities. The principles were elaborated against that background.

36. The first principle set out was:

> "If solvency were understood to mean no more than the fulfilment of contractual obligations, it would be appropriate to use a gross-premium method of valuation (i.e. one under which the net liability is the value of the sums assured, and any existing reversionary bonuses, less the value of the office premiums actually payable reduced by an appropriate allowance for future expenses). It is not considered, however, that this would be satisfactory in relation to with-profit policies. Under with-profit policies policyholders pay premiums greater, and sometimes materially greater, than are required to provide the sums assured on death or maturity. If credit is taken in the valuation for these premiums less an appropriate allowance for expenses, this would mean that amounts included in premiums payable in the future which ought to be available to provide future profits would be capitalized so as to reduce the amount of the liabilities, and that for some years after issue the net liability under a policy would be negative. Thus, an office would be able to fulfil a solvency test using a gross-premium method of valuation, even though it had spent the amounts included in premiums payable in the future which the policyholders would expect to be used to provide profits. Such an office would not, however, be in a position to fulfil the reasonable expectations of its with profit policyholders because it would have little or no prospect of providing profits to them in the future.
>
> Under the net-premium method of valuation, the premiums valued exclude any amounts included in with-profit office premiums which would provide profits to policyholders. Thus, these amounts receivable in the future are not capitalized so as to reduce the amount of the liabilities and, if solvency is demonstrated using a net-premium method, then, broadly speaking, the amounts included in future premiums which should provide profits for

policyholders will, in fact, emerge as surplus from year to year in the future and be available for this purpose. The use of the net-premium method leads to the thought that in relation to with-profit policies the suggested standard does a good deal more than achieve solvency in terms of ensuring the fulfilment of contractual liabilities. It might better be regarded as a standard of good conduct so far as with-profit contracts are concerned.

The net-premium method is also a desirable standard for non-profit business because the loadings in the premiums to provide for contingencies are not capitalized so as to reduce the net liabilities, as they would be if a gross-premium method were used. However, because the net-premium method has no regard to the office premiums actually paid it would not, without some additional safeguard, give sufficiently early warning of insolvency for an office transacting only or mainly non-profit business and whose premium rates were inadequate. A suitable additional safeguard for this purpose is provided by principle 3.

The benefits valued must take account of any options available under the contracts. In particular, the net liabilities must in aggregate exceed the surrender values if these are guaranteed."

37. Skerman was not concerned with the content or meaning of the expression 'policyholders' reasonable expectations'. He was concerned that the actuary should have regard to the reasonable expectations as to participation in future profits in determining the value of liabilities. That required the adoption of a valuation method that avoided setting off against current liabilities the capitalised value of that part of the future flow of premium income that was not related to guaranteed benefits, so leaving surplus generated by that part to emerge over the duration of the contract and to create the bonuses that policyholders reasonably expected to emerge in parallel with it. As already mentioned, Skerman was involved in the discussions in 1972 with officials about the proposed changes in legislation in his capacity as an officer of the Life Offices Association and of the British Insurers Association, and was associated with development of the 'adequacy' test. It is unsurprising that much of the departmental discussion focused on this aspect of PRE.

38. Stewart was clearly deeply involved in preparations for the 1973 Bill. Some of his comments have been referred to. His recollection was that:

"A few years [after the Skerman paper], when insurance legislation was in preparation, the regulators at the Department of Trade instructed their solicitors to include provision for the making of regulations which would require the use of the net-premium method of valuation. They explained that the purpose of this was to satisfy with-profit policyholders' reasonable expectations that there would indeed be profits for them to share. The solicitors then wrote similar instructions to the Parliamentary Draftsman.

When the draft Bill arrived, the regulators were surprised to discover that the words 'policyholders' reasonable expectations' had found their way into the primary legislation. On reflection, they saw no reason to object because it introduced a very desirable degree of flexibility to their restricted powers of intervention.

That is how PRE found its way into the 1973 Act. It started out as an explanation of why the valuation regulations were to specify the use of the net premium method, and ended up as an extension of the regulators' powers, and, of course, responsibilities."

39. However, the departmental papers do not support this precise version of events. On the contrary, careful attention was paid to the drafting of the provision and the justification for it. The provisions were also the subject of intense Parliamentary debate. None of it suggests a technical meaning for the language used. On the other hand, if Ronald Skerman did coin the phrase in his 1966 paper, it is clear that the term did not have any prior established technical meaning.

Stewart also drew my attention to a Faculty discussion of the topic on 16 February 1976 *Actuaries and Long-Term Insurance Business*, a discussion that seems to confirm the impression that the phrase was indeed seen as new by the profession at the time.

Interpretation of PRE

40. The provisions as finally enacted in 1973 were consolidated in the Insurance Companies Act 1982, sections 37(2)(a) and 45(1)(a)[4]. It is in the context of these provisions that the meaning of the expression "policyholders' reasonable expectations" has to be found. At first sight, the expression employs words of ordinary English usage in the context of statutory powers conferred on the regulator in a wide range of specific triggers for action. Context may impress on statutory language some specific meaning, or influence its interpretation. But there is nothing in the context of any of these provisions individually or in the provisions as a whole that might change the meaning of the expression from its ordinary English meaning if that were the appropriate approach to construction. On the contrary, the wide range of circumstances in which the exercise of regulatory power could be competent would tend to support a view that the expression should have its ordinary meaning.

41. The immediate context, subsection 37(2), sets in juxtaposition the criterion of inability to meet liabilities, that is contractual obligations, as the sole ground for intervention in the case of general business, and the criterion of inability to fulfil the reasonable expectations of policyholders in the case of long-term business. Whether or not one construes the word 'or' disjunctively, the selection of a criterion other than that based on contractual liabilities indicates that policyholders' reasonable expectations are wider than contractual rights. The structure and language of the provision would make no sense otherwise. It could hardly be thought to be Parliament's intention that, in the case of long-term business, policyholders' relevant interests should be less ample than their contractual rights. If the relevant interests were co-extensive with contractual rights the distinction drawn within the provision would be redundant.

42. The provision is concerned both with policyholders and potential policyholders. The expression is not constrained by an existing contractual or other legal relationship between the office and the individuals or groups whose interests are relevant to the exercise of the powers. The regulator has to have regard to those who may become policyholders as well as those who have already become policyholders. That aspect of the provision is intelligible in the case of section 41, for example. The regulator might be content that existing policyholders were adequately protected, or exposed to acceptable risks, but consider that no new policyholders should be exposed to risk associated with further expansion of the business. In relation to existing policyholders, the divorce of grounds for intervention from constraints relating to the contract would imply that the interaction of the rights of other classes of policyholder, and of prospective classes of policyholder would equally be relevant to the exercise of the powers. The reasonable expectations of an existing class of with-profits policyholders to participate in surplus could be adversely affected by the creation of a new class of with-profits policyholder with over-riding guaranteed rights.

43. Long-term insurance products, in the typical forms of life assurance policies or annuity contracts, are usually devised by and marketed by the insurer rather than negotiated *ad hoc*. In the case of prospective business the person seeking cover is likely to require information about the products on offer, the benefits available or likely to be available to him, and the cost. It might generally be regarded as reasonable for the potential policyholder to expect that information to be provided in an intelligible form, having regard to the level of sophistication of the client and the

[4] See chapter 15, paragraph 10 et seq for a further discussion of these provisions.

nature and extent of the professional guidance available to him, to be accurate in so far as it is factual, and to be reasonably based in so far as it forecasts future events and circumstances. If the information is provided in documentary form, the prospective policyholder might reasonably expect that the documents met those criteria of intelligibility, accuracy and reasonableness.

44. Paragraph (3) of schedule 2E to the 1982 Act specified that in relevant cases certain information must be provided to prospective policyholders. The person seeking cover might reasonably expect the information provided in terms of that obligation to meet the same criteria of intelligibility, accuracy and reasonableness. If it did not, regulatory action could be initiated. Generally, in the absence of any limiting language in the statutory provisions, where the contract proposed would confer discretionary powers, the prospective policyholder might reasonable expect to receive intelligible and accurate information about the nature of the powers, and reasonable forecasts of the circumstances in which they might be exercised, and how the exercise might affect his interests.

45. Once a contract has been entered into, the progress towards realisation of the benefits contracted for adds another element to the picture, but again the general proposition would be that every policyholder might reasonably expect that all communications, documentary and oral, made by or on behalf of the company met the same criteria of intelligibility, accuracy and reasonableness. Schedule 2E, paragraph 2 stipulated that changes in any of the information required in terms of paragraph 1(3) should be intimated. The same criteria would apply. Particular cases would invariably raise particular issues. For example, the product on offer or contracted for might specify the investment policy to be applied, and generally would do in the case of linked products. That could generate reasonable expectations about the management of the office's investment business. Intelligible, accurate and reasonable information could reasonably be expected about investments made and their performance and assumptions about their future performance. The context, generally, points to a broad interpretation of the criteria for intervention to protect policyholders or prospective policyholders.

46. There is no indication in the Act as to how policyholders' reasonable expectations might be formed, or as to where one might find evidence to support those expectations, generally or in the particular case. Since the emphasis is on policyholders and potential policyholders, it is reasonable to infer that reasonable expectations are a function, at very least, of information communicated to the policyholder or potential policyholder, by whatever means the particular office elects to employ, related to the office's policies and practices. There is, therefore, an intelligible context for the power, which one can define in terms of the life office's business relationships with its policyholders, and policyholders' responses.

47. The expression 'reasonable expectations' does not lack clarity. It occurs in a variety of contexts. The words were used as a criterion for qualifying for pecuniary benefit under the Fatal Accidents Acts 1846 – 1959 where the expression was adopted as a test of dependency. The Courts selected the expression to distinguish the test from one based on legal right, without reference to any technical meaning, and using ordinary language for that purpose. Dependency did not require proof of a legal right to support. On the other hand it was distinguished from mere speculative possibility of benefit. In *Taff Vale Railway Company v Jenkins* [1913] AC 1 at page 7 Lord Atkinson said:

> "I think it has been well established by authority that all that is necessary is that a reasonable expectation of pecuniary benefit should be entertained by the person who sues. It is quite true that the existence of this expectation is an inference of fact – there must be a basis of fact from which the inference can reasonably be drawn."

In *Barnett v Cohen* [1921] 2 KB 461 at page 471 McCardie J. said:

> "I think that the only way to distinguish between the cases where the plaintiff has failed from the cases where he has succeeded is to say that in the former there is a mere speculative possibility of benefit. Whereas in the latter there is a reasonable probability of pecuniary advantage."

48. These views were applied by all three judges in the Court of Appeal in *Davies v Taylor* [1972] 1 QB 286, though Lord Justice Cairns differed in the result[5]. In the House of Lords in that case [1974] 1 AC 225, Lord Morris at page 214 and Viscount Dilhorne at page 217 supported the approach. Although the context was different, the expression was of sufficient clarity and certainty of intent to be adopted and applied by the Court as a test of the availability of remedy. There is nothing in the contemporary papers to suggest that those involved in the preparation of the 1973 Bill were aware of the litigation, though *Davies* was current at the time. But in the light of these cases it would not be possible to hold the view that the test introduced into the 1973 Bill was an actuarial concept, or something particularly adapted to the requirements of the life industry, or an expression that could not be construed as one of ordinary English usage without clear evidence of some established specialist application.

49. In the *Hyman* case, the expression 'policyholders' reasonable expectations' was discussed by the Vice-Chancellor at first instance as follows:

> "PRE and Representations made by the Society to GAR policy holders regarding the final bonus
>
> 77. The relevance of these representations is two fold. First, they are relevant to "policy holders' reasonable expectations" (PRE). ... PRE figured much less prominently in the submissions put before me by Mr Sumption than it had seemed from the contents of the evidence filed on behalf of Mr Hyman would be the case. It is nonetheless a matter which I must take into account in considering the manner in which the Directors exercised their discretionary powers in respect of final bonuses.
>
> 78. PRE has been the subject of debate in the actuarial profession but has no statutory definition. The expression was first used in a statutory context in the Insurance Companies Amendment Act 1973 which gave powers to the Secretary of State to intervene in the affairs of an assurance company on various grounds. One ground was that the company might be unable to meet its liabilities or "the reasonable expectations of policy holders ..." (see sections 12 and 21 of the 1973 Act).
>
> 79. The statutory successors to these provisions are section 37 and 45 of the Insurance Companies Act 1982.
>
> 80. These provisions recognise that policy holders may have a reasonable expectation of benefits over and above their contractually guaranteed benefits. One of the functions of Actuaries appointed to advise assurance companies is, according to the practice standards issued by the Faculty and Institute of Actuaries, to ensure, so far as possible, that the long term business of assurance companies is conducted with regard to PRE.
>
> 81. A Working Party chaired by Mr Brindley, who gave expert evidence on behalf of Mr Hyman, examined the concept and implications of PRE and reported to the Institute in June 1993. The Report pointed out that the primary expectation of policy holders was that their guaranteed benefits would be met in full and that the company's affairs would be managed ethically and competently. The Report concluded that:-
>
>> "The holders [of policies with a discretionary element] may reasonably expect that life offices will behave fairly and responsibly in exercising the discretion which is available to them. They may also expect a reasonable

[5] See especially Megaw LJ at page 298.

> degree of continuity in an office's approach to determining variable charges or benefits",

and that:-

> "in the normal day-to-day actuarial management of a life policy, PRE is synonymous with equity and the almost universal method for measuring it is asset share calculation".

82. I have great sympathy for those commentators who have found PRE to be an elusive and difficult concept. I am not in the least surprised that the Institute of Actuaries set up a Working Party to examine and report on PRE. I would, for my part, be prepared to accept the Working Party's conclusions set out above.

83. The expert witnesses were in agreement that factors that might shape PRE would include:-

> a. the terms of the contract between policy holders and the Society;
>
> b. statements made to the policy holders by the Society;
>
> c. past practice of the Society; and
>
> d. practice in the industry."

50. It is clear that there was not a full and exhaustive debate on policyholders' reasonable expectations at first instance. Counsel concentrated on the contractual issues. But one factor was established: policyholders could have reasonable expectations of benefits beyond their contractual rights, instructed by the factors identified in paragraph 83 of the opinion. I do not share the Vice-Chancellor's sympathy with the actuarial profession: in this context they have been the authors of their own misfortune by seeking to substitute for the straightforward language of the statute tests that are more elusive, such as the 'asset share' test of PRE. (I will discuss industry practice further below.)

51. In *Hyman*, Lord Woolf MR spoke of the policyholder's reasonable expectation "that he would receive his asset share" (paragraph 54). It is clear that he did not mean by that expression what Equitable meant, since his decision was that the practice of allocating differential terminal bonuses as a means of providing asset share, the Society's contention, was illegitimate. But this illustrates the problem: there is no single view as to what constitutes 'asset share'. It is likely that Lord Woolf meant only that the policyholder was entitled to have a full proportionate share of the distributable assets at maturity. In any event his use of the expression was not a definition of its scope. Again there was not a full debate on the issue. In the absence of an authoritative judicial exposition, I consider that the expression should be interpreted as providing a test to be understood according to the ordinary usage of the words employed.

52. On the basis of the decision in *Hyman*, one can say with confidence:

- The expression is not confined to contractual rights. In a question with a life office issuing a policy the policyholder has an unqualified right to expect his contract to be satisfied. If the expression were confined to contractual rights it would be wholly redundant in an absolute sense quite apart from the immediate context. Further one of the express purposes of those who conceived the provision was to reach beyond contractual rights to interests in future benefit in the case of with-profit insurance.
- The expression would not encompass mere speculative possibilities of future benefit: one would be concerned with expectations that had a foundation in practical reality.
- The expectations would have to have a basis in fact for which there was reasonable evidence.

These views are consistent with the intentions of those who proposed the test of intervention in the first place.

53. It would appear to be reasonable to suggest that the factual basis for reasonable expectations would include both the words and the actions of the insurer, as the Vice-Chancellor held. Representations, oral and written, would be obvious sources of evidence on which to build policyholders' and potential policyholders' reasonable expectations. But the actions or lack of action on the part of the insurer would be no less important. An actual pattern of conduct over a period could be as likely to contribute to the reasonable expectations of interested parties as the words used in relation to those actions. Using different language, but reflecting substantially the same meaning, Equitable acknowledged in its 'Bonuses' leaflets in the 1970s that the Society's practice of adding bonuses to sums assured over many years gave rise to a 'natural expectation' that bonuses would continue to be added. In context there may be little difference between 'reasonable' and 'natural' expectations, but more significantly the comment recognised that patterns of conduct may create expectations for the future: this was not a new idea in 1973.

54. Finally, in relation to the interpretation of the provision, it is important to have regard to its generality. The reasonable expectations of policyholders and potential policyholders are not restricted to any particular class of policyholder, nor are they restricted to any particular group of interests. The interests of non-participating policyholders are to be protected as are those of participating policyholders. The non-profit policyholder might have a reasonable expectation that the investment policy and practice of the insurer during the currency of the policy will be such as to ensure that the benefits he has contracted for will be available at maturity. Similarly, such a policyholder might reasonably expect that the pooling of risks during the currency of his policy will not expose him to the risk that the aggregate liabilities of the office at maturity will reduce his policy proceeds to a dividend on the full sum assured. Again, in the case of with-profits business, while future bonuses must be a significant element in the expectations of policyholders, those expectations may reasonably extend to the whole conduct of the business, encompassing the operation of the long-term business as a whole, the approach to new business growth, the investment of the office's funds, the ascertainment of surplus, the smoothing of returns and the operation of bonus policy generally.

55. In summary, the Act does not define policyholders' reasonable expectations, or specify how the expectations may be formed, or where the evidence to support them may be found. However, the concept is not as nebulous or unintelligible as has sometimes been suggested. It is clear that the expression is not confined to contractual rights, though it would not encompass mere speculative possibilities of future benefit, and that to come within the scope of the language used, expectations would have to have a basis in fact for which there was reasonable evidence. That evidence could come from a variety of sources, including written communications from the insurer to the policyholder or potential policyholder, but it could also be found in the customs and practices, the actions and inactions of the insurer.

56. On its terms the Secretary of State's ability to intervene to protect PRE was a powerful weapon available in a wide range of circumstances. That was the basis for GAD's initial apprehension that a wide discretion would extend the scrutiny process and involve a change of approach from that previously established. Ministers resolved those fears by a decision that scrutiny would continue to be based on the examination of the regulatory returns, and that action on the basis of policyholders' reasonable expectations would be reactive to what was found in the returns so as to restrict the workload that a less restrained approach would involve. The provision was deprived of much of its potential as a result. In substance, the responsibility for proper recognition of policyholders' reasonable expectations devolved on the appointed actuary, as an aspect of his duty to report on the valuation, and regulatory response to the issue depended on the returns, and in particular for the aspects of the returns for which the appointed actuary had specific responsibility. That leads to a discussion of the professional and industry approach to PRE.

Actuarial guidance on PRE

57. Professional guidance on the treatment of and response to policyholders' reasonable expectations was published, in very general terms, in the versions of the Faculty and Institute of Actuaries' Guidance Note 1 (GN1) effective from time to time, as an element of the description of the role and functions of the appointed actuary. In version 1, effective 1 May 1975, paragraph 5.1 stated that "The appointed actuary may need to have regard to the provisions of Section 28(1)(a) of the Insurance Companies Act, 1974", the grounds for exercise of regulatory powers at that time. More explicitly, paragraph 7.1 stated:

> "The possibility of... intervention by the Secretary of State on the grounds of the company's being unable to fulfil the reasonable expectations of its policyholders, may arise from factors, some of which are within the control of the company and some are not. To the extent that they are under the control of the company, it is the appointed actuary's duty to assess the limits within which the company must act and to advise the company of the necessity for those limits."

With the substitution of a reference to section 32(2)(a) of the 1982 Act in and after version 1.3, the paragraphs remained the same in versions 1.1 to 1.6.

58. These very general statements left it to the individual appointed actuary to decide whether it was necessary to have regard to the Secretary of State's powers of intervention. Paragraph 7.1 in particular was composed in terms of Delphic obscurity. Whether the goal identified, of acting within limits defined by policyholders' reasonable expectations, so far as it lay within the power of the company, was a proper reflection of the implicit requirements of the legislation might be debated. But the guidance offered no standards of performance that might reflect generally accepted principles or rules of conduct such as one might have expected of a professional body.

59. In the case of a number of large mutual life offices the appointed actuary was an executive, and in some cases was a director, of the society. Equitable presented the extreme case in which, over two separate periods, the appointed actuary was simultaneously chief executive of the Society, and the reporting actuary responsible for advice on the quantification of the technical reserves of the fund for the purposes of the Society's Companies Act financial statements. Barry Sherlock was the first appointed actuary and held office from 1974 until 1982 during which time he was also chief executive. Roy Ranson took over as appointed actuary in January 1982 and went on to hold both offices from 1990 until 1997. Objective assessment of policyholders' reasonable expectations must, of its nature, present problems when the actuary's duties in that regard fall on an employee of the office whose conduct and communications are under review. When the responsible officer is simultaneously responsible for the management of the office, independent assessment of the implications of the marketing, customer relations and actuarial management of the organisation reflects those problems in an aggravated form. The professional bodies recognised no impropriety in the joint holding of offices including that of appointed actuary. There was a clear need for standards of professional conduct and practice to be established against which to measure the performance of individual appointed actuaries.

60. On 16 February 1976 the Under Secretary of State at the Department of Trade told the Faculty of Actuaries that:

> "The Secretary of State is now required to have regard not only to contractual obligations but also to the reasonable expectations of life assurance policyholders. What expectations might be reasonable in any particular case will have to be determined in the light of the circumstances, but it is certainly <u>our</u> expectation that companies which charge large premiums, with a loading for bonuses, will in fact make profits to be shared with their policyholders, and

will not take credit for the value of future bonus loadings so that they can hold smaller reserves than would a non-profit company. On the other hand, we do not envisage any general intervention in the determination of the amount of surplus to be disclosed by companies, or the manner in which it is to be distributed between policyholders of different generations or different classes. We would hope that this could continue to be left to the directors acting on the advice of their actuaries."

The comment was limited in scope. It focused on bonus distribution as the central feature of policyholders' reasonable expectations, and reflected the Skerman approach to valuation in discouraging taking credit for bonus loadings in future premiums. It was nevertheless to be some considerable time before the professional bodies responded in similar fashion.

61. Version 2 of GN1 (effective from 1 December 1988) adopted an altered format. Paragraph 1.1 stated:

> "It is incumbent on all appointed actuaries to ensure, so far as is within their authority, that long-term business is operated on sound financial lines".

62. It repeated that the appointed actuary might need to have regard to section 37(2)(a) at paragraph 5.2. Paragraph 7.2 followed the earlier version. In respect of the appointed actuary's valuation and recommendations for bonus allocation, paragraph 8.3.4 stated:

> "He must justify his recommendations regarding the allocation and its consequences (if any) for the conduct of the company's business by reference as appropriate to:
>
> (a) his appraisal of the relevant experience;
>
> (b) his understanding of the company's financial and business objectives;
>
> (c) his assessment of the company's continuing ability to meet its statutory solvency requirement;
>
> (d) his interpretation of the reasonable expectations of the company's policyholders having regard to (a), (b) and (c). He should assume that among the conditions for the fulfilment of those expectations are:
>
> (i) that, in the recognition and allocation of profits in accordance with the company's terms of participation and its policy in respect of the (nature and timing of allocations), groups of participating policies are appropriately and equitably distinguished having regard inter alia to the terms of the policies, their duration and their relevant pooled experience, and
>
> (ii) that the company conducts its affairs, including its new business and investment strategies, with due regard to its financial resources."

63. Version 2.1 was in substantially the same terms. The specific factors identified in the Version 2 forms made no reference to the contract between policyholders and the office; communications with policyholders; practice of the office, or practice of the industry. Positively, the emphasis was on factors that related to the global position of the office, with the exception of factor (d)(i) which recognised variations in the interests of cohorts of policyholders.

64. Version 3 was effective from 1 July 1992. The first material change was in the introduction. The duty of the appointed actuary was expanded as follows:

> "a. It is incumbent on all Appointed Actuaries to ensure, so far as is within their authority, that the long-term business of the company is operated on

sound financial lines and with regard to its policyholders' reasonable expectations."

65. Section 3.3 stated:

"a. It is part of the Appointed Actuary's continuing responsibility to advise the company of his interpretation of its policyholders' reasonable expectations. In general terms he should have regard to the broad nature of the company and its approach to the treatment of policyholders both individually and (where appropriate) as a group *vis-a-vis* shareholders.

b. When a significant change is likely to take place, the Appointed Actuary should take all reasonable steps to ensure that the company appreciates the implications for the reasonable expectations of its policyholders. It is also incumbent upon the Appointed Actuary to take all reasonable steps to ensure that the company's incoming policyholders should not be misled as to their expectations."

66. Section 6.3. stated:

"a. The Appointed Actuary must use liability valuation methods that are appropriate to the contracts in question, taking into account not only the principal benefits, but any ancillary benefits such as surrender and paid-up values and any options. When assessing the liabilities of the long-term business of the company he must also have regard to policyholders' reasonable expectations."

67. Paragraphs 7.2 and 8.3.4 were in the same terms as before. Section 3.3 reflected a move towards recognition of relationships with individual policyholders and groups of policyholders. The GN1 working party for version 3 was chaired by Mike Ross then of Scottish Widows. He considered that it would be inadvisable not to draw attention to the importance of policyholders' reasonable expectations in GN1. Scottish Widows' practice was to recognise prospective terminal bonus in amounts held in the investment reserve, later fund for future appropriations.

The Brindley Working Group

68. The development of GN1 mentioned so far may be taken to reflect developing attitudes within the life industry to the relevance of policyholders' reasonable expectations down to 1992. There was no well-formulated industry view of potential policyholders' reasonable expectations until the mid-1990s at the earliest. The Brindley working party on PRE was set up in September 1989, and presented its first report on 25 April 1990. It is appropriate to look to the working party's reports to assess the wider industry view, with this general caveat, that the paper proceeded on the basis of a 'technical' meaning for the expression based on expert views developed after the 1973 Act came into force.

69. In the first report of the working party, appendix A.1, it was stated:

"a. The expression "policyholders' reasonable expectations" (PRE) is now in common currency. It is used both in the normal meaning of the words in the English language and also as if it were a technical term. In this paper, we are concerned with what the "technical" term means now to the actuarial profession."

70. It is not uncommon for professional jargon to appropriate ordinary words and to seek to imbue them with a technical mystery that is impenetrable to the ordinary member of society. Actuaries are not distinguished in this respect from other professional groups. However, in this case, in attempting to put a professional gloss on the language of the Act, the profession appears, no doubt unintentionally, to have seriously misled itself. The context in which PRE was relevant to actuaries was defined by statute and by the regulatory obligations of the appointed actuary. For those purposes a 'technical' meaning of the expression could only be relevant if it

reflected a proper interpretation of the legislation. But the information collated by Brindley offers the best reflection of actual attitudes at the time.

Box 13.1: Brindley working group: 7 cases where PRE had arisen

i. The transfer of long term with-profits business from the UK branch of an overseas mutual company to a UK authorised proprietary company whose ultimate shareholder was the overseas mutual company.

The principal issue raised was how the accumulated UK free assets should be divided between the transferring with-profit policyholders and the rest of the continuing UK business.

ii. The establishment of a with-profit sub-fund within a long-term business fund which had previously included both with-profit and non-profit business.

The issues included the size of the initial allocation of surplus to the new sub-fund and the remuneration, if any, of the existing with-profit policyholders for their loss of profits from non-profit business.

iii. The demutualisation of a mutual life insurance company and its subsequent acquisition by another financial institution.

The issue was the amount to be paid to existing with-profit policyholders to compensate them for their loss of proprietary rights and the protection of the existing policyholders' ongoing rights.

iv. The closure to new business of a mutual company which was considered unable to maintain its current level of bonuses due to inadequate financial resources.

The issue was whether the mutual prior to closing to new business was giving its new policyholders reasonable expectations concerning their bonuses.

v. The merger of a UK mutual insurance company into the fund of an overseas mutual company, the merged fund remaining open to new business.

The issue was the amount to be paid to existing with-profit policyholders to compensate them for the reduction of proprietary rights and the protection for the existing policyholders' ongoing rights.

vi. The merger of industrial business and ordinary business assets so that surplus contributed by past generations of industrial business policyholders could be used to finance the current growth of ordinary business.

The issues were as to the conditions under which the surplus could arguably have been regarded as deriving from the industrial business, and could be used to finance the growth in ordinary business.

vii. An increase in the proportion of distributed profits paid to shareholders.

The issue was whether it was reasonable for the with-profit policyholders to expect that the established proportion of profits should be maintained.

71. Between September 1989 and April 1990 the working party consulted widely and interviewed numbers of appointed actuaries some of whom had had practical experience in dealing with particular PRE issues. At that stage they encountered actuaries who thought it unnecessary to consider PRE very deeply because

'policyholders would not understand it anyway'.[6] The working party noted that those views were 'largely rejected" by the profession, and in particular they were rejected by almost all of those interviewed. But it is not insignificant that between 1989 and 1990 there were members of the profession, and in particular members who held office as appointed actuaries of U.K. life offices, who entertained views at that extreme of the spectrum. The profession appears to have accommodated such views without taking steps to correct the impression created.

72. The general view was that the "expression should be interpreted in the context of professional advisers acting on behalf of policyholders, the courts, the press and similarly well informed observers" of the industry. The focal group for discussion of the reasonable expectations of policyholders was therefore taken to be reasonably sophisticated financial observers. Since the provision provided a criterion for regulatory intervention, the assumption of some degree of understanding of the issue involved might be reasonable. But Parliament had not set out to protect only those capable of helping themselves with or without professional guidance. The regulator had to address the position of the general body of policyholders, and one might have expected the professions to have adopted a similar view. The constituency that any person seeking to assess policyholders' reasonable expectations had to have in mind had to reflect the real population of policyholders, not simply a component of it that had relevant financial expertise.

73. The authors found no specific instances where the Secretary of State had invoked his powers to intervene on the grounds that policyholders' reasonable expectations were not being met. But there were situations in which DTI had advised companies of the steps that were required to avoid intervention. The report set out the range of situations encountered. There were seven cases where considerations of policyholders' reasonable expectations had arisen, which are set out in Box 13.1 opposite.

74. Proprietary with-profit offices were identified as raising particular issues relating to policyholders' reasonable expectations because of the potential conflicts between policyholders and shareholders. Other such areas mentioned were:

i. The use of separate companies to provide services to the life fund for which a fee including a profit margin would be charged.

ii. The practice of charging tax on pension profits to the long-term fund rather than deducting it from the transfer to shareholders.

iii. The situation where new non-profit business of a type previously written in a with-profit fund was subsequently written in a fund all of whose profits went to shareholders. This might result in the transfer of goodwill.

The cases identified illustrated situations in which policyholders' reasonable expectations could have particular significance. There is no difficulty with the identification of cases of possible conflict as giving rise to specific PRE issues. There would be difficulty in generalising on the basis of the specific examples set out. The views that emerged from the consultation are summarised in Box 13.2 overleaf.

75. There are difficulties with some of these features. In the context of the cooling off provisions in the 1982 Act, schedule 2E paragraph 1(4)(e) required surrender and paid-up values to be indicated along with "the extent to which such values are guaranteed". Compliance with the provision was an important step in the initial communications between the office and a potential policyholder. The view in paragraph 3.1 of the report that the "primary expectation of policyholders is that all guaranteed benefits will be met in full." cannot be correct; anything communicated in the initial information pack would be relevant to the policyholder's primary expectation. In the particular provision guarantees are envisaged as an aspect of value, not as a measure of the value expected. Further it is clear from the earlier

[6] I understand that one respondent protested that his office's policies were sold by people who did not understand what they were selling to people who did not understand what they were buying.

part of this discussion that the provision was designed specifically to cover non-guaranteed benefits. It might have been nearer to a general rule, if one were justified at all, to say that the policyholder had a reasonable expectation that the benefits promised would be paid at maturity, those benefits comprising guaranteed benefits and benefits accruing from the prudent and competent management of the fund. But the real problem lay in the profession selecting one element of the total return and elevating it into primacy without statutory authority, largely as a reflection of views held about future bonus levels, and terminal bonuses in particular.

Box 13.2: Brindley working group: elements of PRE

Actuaries thought that policyholders' reasonable expectations would be or include:

- The primary expectation that all guaranteed benefits would be met in full;
- The fundamental expectation that the company's affairs would be managed ethically with due competence and diligence;
- The reasonable expectation that discretionary powers would be exercised fairly and responsibly;
- The expectation of a reasonable degree of continuity in determining variable charges and benefits;
- For with-profits business, a reasonable expectation that total policy proceeds would reflect the accumulated value of premiums paid less expenses and the cost of risk benefits. In actuarial terminology, asset share should be the starting point subject to smoothing, with gradual changes in assumptions;
- A reasonable expectation of an investment policy within industry norms, absent prior notice of an intention to pursue an unusual policy;
- In proprietary offices, prior intimation of changes in the basis for determining shareholders' interests in profits;
- (In some actuaries' views) a reasonable expectation that assets share would be a cap on policy proceeds;
- A reasonable expectation that there might be cross-class support by the use of free reserves;
- A reasonable expectation of stable charges;
- A reasonable expectation of gradual change rather than discrete major changes;
- A reasonable expectation of consultation before radical change, including a major change in the level of discretionary charges.

76. The report discussed 'asset share' as an element in PRE. Where 'asset share' is introduced into the pre-contract or contractual material, or by literature that communicates to policyholders that asset share is a factor in determining interests, (as has been the case for most of the 1990s and in current practice) that circumstance may make it part of the factual matrix defining the scope of PRE in the particular case. In such a case the term would require to be defined or it would be necessary for its application to be described, and the treatment of the term might then vary. In general there is no obvious justification for identifying PRE with 'asset share' in the language of the Act.

77. The report sought to 'conceptualise' a statutory test of regulatory intervention in terms of actuarial practice. That was unfortunate, and it may have diverted attention from the substantive issues. The regulator identified by the Act was

initially DTI and subsequently HM Treasury. The regulator had actuarial advice available from GAD and later FSA performed the relevant functions. But the Government Actuary was not the regulator, and Parliament did not subordinate the exercise of the regulatory function to actuarial opinion.

78. Another illustration of a flawed approach related to prospective policyholders. With reference to the different provisions of Finance Act 1989, the report stated that "the value of PRE before the commencement of a policy is nil". A company may fail to obtain a deduction in computing its taxable profits for a mathematical reserve for liabilities prior to the conclusion of the contract: that was the focus of the tax provision. But it is not at all clear why the comment was made in a paper seeking to explore PRE generally and with particular reference to prudential regulation in relation to which Parliament had stipulated that potential policyholders' interest had to be considered. If there were regulatory intervention based on pre-contractual marketing malpractice it could provide a basis for claims against the company that would require the recognition of a liability that would be ignored on this approach. The comment reflected a view that only those matters that are reflected in the long-term liabilities of the office were relevant to PRE.

79. In the absence of special circumstances, PRE had a low prominence for many actuaries. Virtually all of those interviewed thought the term was synonymous with 'the concept of fairness' in with-profits business. It was not greatly considered in relation to other classes of business. There was a widespread belief that PRE could be measured in part off the league tables of policy proceeds. Publications were thought to be important. The report concluded:

> "The principal points which have emerged are:
>
> i. in the normal day-to-day actuarial management of a life office PRE is virtually synonymous with equity and the almost universal method for measuring it is asset-share calculations (it is, naturally, widely accepted that there are differing ways of calculating asset-shares).
>
> ii. in the normal course of events any orphan surplus in an office does not form part of the reasonable expectations of (with-profits) policyholders, since they could not have 'reasonably expected' its distribution when they effected their policies.
>
> iii. in the circumstances of a 'major change' in a life office (such as de-mutualisation), policyholders may reasonably expect that the proposed new arrangements do not disadvantage them as compared with the option of a closed fund. Our profession therefore should make the advantages and disadvantages of each option clear and recommend a closed fund if it is in the existing policyholders' interests.
>
> iv. for with-profits business gradual change is acceptable, particularly if communicated to policyholders, whereas sudden change is not. Changes in the company's levels of payment would be by reference both to previous levels of payment and to standing in the market place.
>
> v. for non-profit business any changes should be consistent with market practice. Thus reflecting changes in market levels of charges, perhaps due to inflation, is reasonable, increases to recoup new business expense over-runs are not."

80. The report reflected a miscellany of views and conclusions. Many of them appear to be reflections of particular experiences. Few can be accommodated as elements of a well-developed thesis. For some, it would appear that in the case of existing policyholders there was a notion that the policyholder's right to 'asset share' had become a surrogate for the statutory criterion, but that 'naturally' there were

differing ways of calculating 'asset shares'. If valid, this would amount to substituting one unknown for another if indeed the expression 'policyholders' reasonable expectations' were mysterious.

81. The Brindley working party's second paper was published some months after version 3 of GN1 on 26 October 1992 and reflected the revised terms of the guidance note. The second paper set out a series of reasoned recommendations. The linking of PRE to the obligation to operate the business on sound financial lines was thought to signal a material change in emphasis. The working party recommended:

> "All Appointed Actuaries should report formally to their Boards annually regarding their interpretation of PRE and the way in which their interpretation is being implemented and communicated by the company."

The prevalence of league tables of policy proceeds made it necessary to explain levels of payout, which would necessarily reflect terminal bonus in the case of with-profits business. Recommendation 2 was:

> "All Appointed Actuaries should make available at least internally to the company an analysis of current levels of payouts under with-profit policies analysed by the source of the profit. In addition, for each source the Appointed Actuary should state his opinion as to whether it will continue."

The with-profits guide published the core policies of the company. Other literature was important. Recommendation 3 was:

> "The statements made in the company's with-profits guide should be submitted to the Board for formal approval. The appointed Actuary should endeavour to ensure that suitably abbreviated summaries are included in all literature for contracts offering with-profits options."

Recommendation 4 sought to deal with the sales process:

> "The Appointed Actuary should provide input to the training given to sales representatives of the company with a view to ensuring that they accurately represent to intermediaries or potential policyholders the company's view on PRE."

Recommendation 5 related to proprietary companies and the risk of conflict of interest:

> "Appointed Actuaries should draw the attention of their Boards to areas where potential conflict exists between policyholders and shareholders and recommend action to deal with potential conflicts. In the event of a material change in such aspects of the company's practice the Appointed Actuary should formally report these changes to the Board and quantify the financial effect on policyholders and shareholders."

In relation to discretionary charges and benefits, recommendation 6 was:

> "Appointed Actuaries should use their best endeavours to ensure that companies adopt a clear and consistent approach towards discretionary charges and benefits. Further, this approach should be specifically described to policyholders in plain English."

The assessment of liabilities with regard to PRE raised a number of issues. It was said that valuation methods should relate to the reasonable likelihood of achieving profit levels. Terminal bonus levels required to be considered in relation to the reserves to provide for PRE. Reversionary bonus rates might remain unchanged or move with gilt yields unless policyholders were told, and their reasonable expectations modified. Recommendation 7 was:

> "In reporting on the results of a valuation, the Appointed Actuary should include statements on the extent to which the valuation method used takes account of policyholders' reasonable expectations, with particular reference to the suitability of discontinuance and expense assumptions, the relationship

> between reserves and asset shares and the maintainability of current reversionary bonus. The implications for the company's with-profit guide and other literature should be discussed."

Recommendation 8 was that there should be a report in writing describing the company's attitude to PRE, and a style was offered. Recommendation 9 set out a range of items to be dealt with in the Actuary's report on allocation. If these recommendations had been accepted and had become the basis of generally accepted practice there would have been a significant stride forward in the profession's understanding of practice standards. The report went out for discussion and comment.

82. The working party's third report was published in June 1993. It set out the profession's reactions to the second report. The second report was criticised as having been too prescriptive:

> "Virtually every person consulted had this reaction to some degree and at the extreme it amounted to a very firm rejection of any prescription of this kind and a feeling that the profession is better served by leaving individual actuaries to judge the situation in the particular circumstances of their own company."

83. Reporting to the 'Board' was said to fail to take account of the wide range of structures in the industry. Reporting to a 'seat of power' was suggested as an alternative. There was a widespread general reaction that there was not really a problem with PRE. The report commented that:

> "At the extreme this bordered on complacency."

Some actuaries did not reveal asset shares even internally. It appeared to be recognised that PRE was emerging as a problem. But responses to the individual questions were so varied as to indicate a lack of any coherent view within the profession as to a set of common standards or a common approach to the topic.

84. Version 4 of GN1 was published with effect from 30 December 1994. In view of the Brindley working party findings, and in particular the responses reflected in the third report, the significant aspect of its terms was that they were generally consistent with the third version. Apart from minor changes of language, the passages identified above were all unchanged. Brindley's recommendations were not reflected in any respect.

85. In the Spring of 1995 the Life Board Research Committee set up a working party on 'orphan estates'. The working party reported on 30 September 1995, and its deliberations were set out in a discussion paper presented to the Institute and Faculty in June and November 1996 respectively. The expression 'orphan estate' was changed to 'unattributed estate' and then to 'inherited estate'. It was defined as:

> "... the residual part of the long-term business fund assets after setting aside that part of the assets sufficient to satisfy the obligations owed to all the fund's policyholders (including their reasonable expectations), shareholders and creditors."

The definition was geared to the requirements of a proprietary company. The central issues dealt with were concerned with the respective interests of shareholders and policyholders in the estate. The working party's views of policyholders' reasonable expectations was therefore a material factor in the advice.

86. The working party report stated:

> "Central to the quantification of the UA [unattributed assets] is the question of the reasonable expectations of policyholders. Policyholders have a contractual right to the benefits guaranteed under their policies including bonuses already declared. In addition legislation implies, but does not directly impose, an obligation for the company to meet the reasonable expectations of policyholders. PRE is referred to but not defined by legislation. The Courts

have not had an opportunity of interpreting them. It is however generally accepted within the actuarial profession that PRE is formed and influenced by:

(a) any reference to participating rights in the company's articles of association

(b) promotional and publicity material and subsequent statements as to the company's bonus philosophy and the entitlement of policyholders to a share in profits

(c) the with profits guide

(d) the history and past practice of the company

(e) practice within the life industry generally.

The interpretation given to these items would be that of an expert and not that of a lay person."

PRE now figured more prominently in professional papers.

87. The discussion of PRE in the paper was in general derivative. The specific application to inherited estates in competitions between policyholders and shareholders is not relevant for present purposes. Only a few points require note. The paper set out that reasonable expectations were a minimum, not a maximum 'obligation'. The paper referred to the practice of some offices in the recent past years of setting maturity payouts at levels in excess of asset shares calculated on realistic bases.

88. In a paper presented by Scott and others to the Faculty of Actuaries on 15 January 1996, and to the Institute of Actuaries on 26 February 1996[7], the current net premium method of valuation for regulatory purposes was said to be subject to a range of criticisms, including its unsuitability for single premium with-profits business and flexible annuities. It was said to be artificial in respect that it made no explicit allowance for renewal expenses or for future bonuses. In particular, it made no specific allowance for terminal bonus, which by then represented a significant part of the policyholder's reasonable expectations. It was pointed out that the very nature of the selling process meant that offices generated policyholders' future expectations regarding their benefits whether by market practice, statements made while selling that class of business, or through bonus notices and other communications to policyholders.

89. The paper stated:

"It may also be argued that the regulations do not deal sufficiently rigorously with PRE and, in particular, future bonuses. The new regulations do specify that due regard has to be paid to PRE, a requirement that has been in actuarial Guidance Note GNI for some time. It is not expected that the inclusion of PRE in the regulations will change companies' approach to the valuation of with profits policies. Under conventional with-profits policies, the use of the net premium method makes an implicit reserve for reversionary bonuses by using a suitably low rate of interest. However, it is not clear how this implicit approach relates to the actual level of reversionary bonuses declared, nor does the method make any direct provision for terminal bonuses, which currently make up a large part of the proceeds of claims under with-profits policies."

90. The authors proposed a dual valuation approach that has resonance in current proposals. They proposed :

i. A 'statutory solvency reserve' (SSR), which would be a conservative gross premium valuation of the benefits which had been guaranteed to the policyholder, together with some allowance for future bonuses where

[7] An Alternative to the Net Premium Valuation Method for Statutory Reporting, Scott et al.

appropriate, calculated on a basis that complied with the requirements of the EU 3rd life directive; and

ii. A 'realistic policy liability' (RPL), which would be a realistic gross premium valuation of the benefits that policyholders could reasonably expect in the future, calculated using best estimate assumptions of future experience, incorporating prudent margins that would be released over the term of the contract.

91. The description of the SSR method was not prescriptive of the method of providing for future bonus, but excluded specific provision for terminal bonus on the view that, given its discretionary nature, in the event of adverse experience it could be reduced or even eliminated, albeit subject, normally, to some degree of smoothing and the need to satisfy the reasonable expectations of policyholders.

92. The RPL basis would be a realistic gross premium valuation liability, incorporating some prudent margins. In the case of conventional with-profits business, the calculation would include a reserve for future bonuses supported by the investment and other assumptions in the valuation liability calculation. The reversionary and terminal bonuses should be those which the office would declare if the actual experience were in line with the valuation. The office should make allowance for an appropriate split between reversionary and terminal bonuses in accordance with its normal philosophy and the reasonable expectations of its policyholders. The bonuses might be determined by reference to policy asset shares. If asset shares were used, they should be based on the office's past experience of investment return and expenses. Projections of asset shares should be consistent with the assumptions used in the valuation basis.

93. In the case of unitised with-profits business, the principles should be the same as those for conventional contracts. The liability should represent a best estimate of the amount required at the valuation date to pay future benefits, including both reversionary and terminal bonuses, with the option of using asset shares as a guide to the bonus distribution. The bonuses assumed should be those that the office would declare if its experience was in line with the assumptions in the valuation basis

94. The authors' proposals did not win immediate support. Version 5 of GN1 was effective from 1 September 1996. Paragraph 1.1. carried forward the terms of the previous version. Paragraph 3.3 was in the same terms. Paragraphs 5.7 and 5.8 were new:

> "5.7. Some companies may include in their policy contracts a requirement that terms be determined by the Appointed Actuary, or by the company's actuary or by the company on the advice of the Appointed Actuary. For example, policy expense charges and mortality and morbidity charges may be treated in this way, as may market value adjustments to unitised with-profits contracts. In determining such terms, or in providing advice to the company in this area, the Appointed Actuary should have regard to policyholders' reasonable expectations and to existing legislation, including that covering unfair contract terms, where relevant.
>
> 5.8. For unit linked business, unit pricing, fund charges, and deductions in respect of taxation are key elements of policyholders' reasonable expectations, to the extent that the company has discretion in applying its policy conditions. The Appointed Actuary must be satisfied that all discretionary elements of unit pricing and fund charges are applied consistently with policyholders' reasonable expectations..."

Three specific instances in which policyholders' reasonable expectations should be considered were prescribed. Paragraphs 6.3, 7.2, and 8.3.4 were in the same terms as before. There was no material development of the guidance.

95. The debate within the profession was taken up in a paper by Wright and others presented to the Faculty on 16 March and to the Institute on 27 April 1998[8]. The paper recorded that the tone of the two sessional meetings on the Scott proposals was generally unfavourable towards the proposal to publish a realistic policy liability in the annual supervisory returns, notwithstanding general support for 'true and fair' reporting in Companies Act accounts. By contrast, the suggestion that the current statutory regime should be subject to overhaul received rather greater (though not universal) support. The paper proceeded to discuss reform in that context.

96. The paper noted that there had been growing recognition of the need to interpret and safeguard policyholders' reasonable expectations. It was a common theme that the calculation of mathematical reserves might not have kept pace with the development of the concept of PRE, despite what was described as the more searching questions included in schedule 4 of the statutory returns completed under the Insurance Companies (Accounts and Statements) Regulations 1996.

97. However, the working party proceeded on the basis that it was a fundamental principle that the valuation reserve in both basic and resilience test scenarios could exclude any terminal bonus element. This was said to preserve the "valuable concession secured for the U.K. during the negotiations concerning the Directive". I have referred to that matter already[9]. In proposing how the dilemma of recognising PRE without valuing terminal bonus, the paper proceeded:

> "Terminal bonus clearly does form part of PRE, but testing for the ability to continue to pay an appropriate level of this bonus should be carried out on a realistic basis, assuming, for example, capital growth on equities and property and realistic levels of discontinuances. The statutory basis, as restricted by the Directive, is not considered suitable for this purpose. However, when considering whether the reserve should be less than the face (or funded) value of the unit fund, the Working Party interpreted current regulations as requiring that the minimum acceptable valuation reserve must have regard to PRE on surrender/transfer (again in both the basic and resilience test scenarios). In practice this will mean that, when the PRE surrender value is less than the face (or funded) value of the unit fund, then the reserve cannot be less than the PRE surrender value."

PRE surrender value was defined. It was recognised that the exclusion of any allowance for terminal bonus required some guidance in two areas:

(1) to prevent circumvention of the intention behind the regulations, it needed to be made clear that what was, or was not, terminal bonus depended on substance rather than form. A bonus which a policyholder would reasonably expect to be permanent (on a contractual claim arising) must be valued as such, notwithstanding that it was described as a terminal bonus in the supervisory returns; and

(2) the inter-relationship between any market value adjustment (MVA) or other similar surrender value adjustment and terminal bonus needed to be clarified.

The Working Party came to the conclusion that the only satisfactory approach which would not produce anomalous results was to require any MVA or similar surrender value adjustment to be taken, in the first instance, against any accrued terminal bonus cushion.

98. It would be inappropriate in a report such as this to engage in a detailed criticism of a professional paper without having the qualifications and experience required. Inability fully to comprehend the intricacies of argument may well be

[8] A Review of the statutory valuation of long-term insurance business in the United Kingdom, P. W. Wright, BA, FIA, ACII and others.

[9] See chapter 10, paragraph 32.

explicable solely on lack of necessary insight. However, it is plain that the authors of this paper (who included two GAD actuaries mentioned elsewhere) considered that there could be adequate reserving without provision for terminal bonus. They subscribed to the basic approach that contributed to Equitable's serious under-funding throughout the 1990s.

99. Version 5.1 of the guidance note was published with effect from 1 December 1998. There were no alterations in the relevant paragraphs. GN1 was revised following the enactment of the Financial Services and Markets Act 2000. The proposed new text was set out in an exposure draft and the final version reflected a number of changes derived from the process. The Corley report came too late for its recommendations to be considered. The 2000 Act had excluded references to policyholders' reasonable expectations. However, the new text continued to make references to the test. In paragraph 3.6 it was stated:

> "Liabilities to policyholders are defined in the FSA Handbook Glossary as including any liability arising from the requirement to treat customers fairly, including with regard to policyholders' reasonable expectations. The appointed actuary must ensure that the insurer's management are aware at all times of his or her interpretation of its policyholders' reasonable expectations .. and of any other obligations to treat customers fairly which need to be taken into account."

100. The text continued broadly in terms of the former paragraph 3.3. In section 7, on allocation of profits, the appointed actuary was required to state his interpretation of policyholders' reasonable expectations in terms of the former paragraph 7.2. As revised at December 2001, the standard duties of the actuary were described in some detail, following the FSMA 2000, in the Manual of Actuarial Practice.

101. Despite the efforts of the Brindley working party, and developing thought in professional papers, the actuarial profession as a whole failed to develop any coherent principles or rules of practice by which to test objectively the approach of an actuary, and in particular an appointed actuary, to the ascertainment of and provision to secure the satisfaction of policyholders' reasonable expectations. The profession resisted prescription. The individual judgment of the appointed actuary prevailed. But it did so in a context in which the profession had failed to adopt any generally acceptable professional understanding of what policyholders' reasonable expectations might comprise and how they might be generated and tested. Formation of a general rule of practice or a generally accepted standard for the recognition of accrued final bonus in particular was avoided.

Regulatory Interpretation of PRE

102. So far in this chapter I have described the origin of the PRE test in the Insurance Companies Acts, and some of the development of the actuarial profession's approach to PRE. Whatever attempts may have been made by the actuarial profession to appropriate the responsibility for deciding what constituted PRE, the test was at all times a regulatory one, a trigger for regulatory intervention. While the profession developed its thinking, there was also considerable activity among the regulators, and 'reasonable expectations' came to be construed in much broader terms in departmental exchanges than those reflected in the professional guidance notes.

103. A newly appointed senior line supervisor[10], who as it happens also had responsibility for Equitable among other life offices, wrote a memo on the subject on 18 April 1986. The context is unclear, since the document was only available to the inquiry as circulated much later, but it set out the Parliamentary history of the provision, using the notes on clauses for the 1973 Act and statements made in

[10] See chapter 15, paragraphs 39 to 44, for explanation of the terms used to refer to regulators' grades.

Parliament as his sources. The note included the following quotation from an internal document, undated, which the supervisor warned did not deal with 'reasonable expectations' in a definitive way. He suggested that some of the argumentation might not have been realistic, but he included it as an illustration of the insurance division's thinking immediately after the Act:

> "The reference to 'reasonable expectations' may present difficulties of interpretation and policy is likely to evolve from cases. The underlying intention however is that as a minimum any forecast of benefits made by a company should prima facie be regarded as establishing an expectation that it will be approximately realised, provided that any stated assumptions have been fulfilled. A stable performance over an extended period might be held to establish expectations, other things being equal, of continuing stability. Where there is no such basis it may be that the performance of competitors in similar contexts will provide a guide, but this is obviously much less easy to assert and a fairly wide divergence would probably be required to justify action. On the other hand once reasonable expectations have been determined, one can consider the risk of failure to satisfy them at some time in the future eg if a company has failed to establish a viable portfolio whether its funds are likely to be eroded by normal management costs on too narrow a basis.
>
> The reference to "potential" policyholders ... is important in demonstrating the forward looking use of the powers which is contemplated and implying the desirability of early intervention to secure recovery rather than merely minimising the effects of expected deterioration. ("Potential" policyholders are of course directly protected by the exercise of the powers of restriction and premium limitation)."

Arthur Russell, head of insurance, circulated the note on 21 June 1988, when the department became involved in more wide-ranging discussions. He commented that the note demonstrated the poverty of past references to the subject.

104. In March 1988 the expression "reasonable expectations" was adopted in discussing the requirements of true and fair accounting, with cross-reference to its use in the insurance context. On 10 June 1988 Russell sent a first draft of a proposed submission to the Consumer Affairs Minister for guidance on a general policy position on PRE in relation to insurance. He observed

> "3. The powers to protect the "reasonable expectations" of policyholders and potential policyholders were taken in the Insurance Acts of 1973 but there have been no public statements of how the Department sees its function under the powers. Without a statement clarifying the Department's position there is always the risk that policyholders will want to put a very wide interpretation on the obligation of the Department to protect their reasonable expectations. The Department could be subject to criticism if policyholders suffer severe bonus reductions because of a failure of the long term fund's investment policy even though in every other respect the company met all the requirements of the Insurance Companies Act. While investment returns have prospered, there has been no particular reason to set out the Department's role, but ... we have now reached a point where it seems likely that the generality of life companies will have to reduce their bonus levels. ..."

The assumption that the company met all the requirements of the Insurance Companies Act included of necessity the assumption that the requirements of statutory solvency were met.

105. The draft suggested that the ordinary risks that had to be accepted by policyholders included slippage due to investment policy going awry. But it continued:

> "6. But suppose the Department had reason to think that slipping investment return was primarily due to a change for the worse in the skill and competence with which the company had conducted itself in the past.

> 7. For the change to be apparent to the Department and GAD and to be clearly attributable to a deterioration in skill and competence, the change would need to be substantial, and indeed so substantial that it would probably come eventually to the notice of policyholders.
>
> 8. In these circumstances, I think that the Department has no option other than to take action. It would need to ensure that the company does have a plan of action to remedy the situation, and if necessary, encourage it to merge with another company. Above all the Department would need to ensure that its advertisement and sales effort reflected its reduced position rather than the palmy days when it stood high in the league tables.
>
> 9. Clearly under such a policy there will be very difficult and awkward areas of judgment. ..."

The paper went on to discuss other areas of intervention. It dealt with reorganisations. It discussed the possibility of intervention where distribution policy appeared too cautious, resulting in the build-up of excessive free reserves. The draft provoked considerable internal discussion.

106. Having received comments, Russell circulated a revised draft of the submission on 27 June 1988. The submission had now been extended to include published material from the 18 April note referred to above. The draft extended the discussion of the department's general policy position.

107. GAD became involved. George Newton, who was directing actuary for the insurance directorate at GAD from 1982 to 1988, provided a copy of a memorandum he had written on 21 September 1987 on an argument that had surfaced that section 45(2) of the 1982 Act inhibited the exercise of the Department's powers generally rather than solely in respect of investment management. On 8 July 1988 Newton wrote a long memorandum to Russell and others:

> "I doubt whether much purpose is served by going in any detail into the origins of the "reasonable expectations" provision ... but I would do so at least in order to correct what I have now discovered is a distorted version of history which I have been instrumental in spreading around.
>
> GAD folklore has for long had it that the origin of the reference to "reasonable expectations" in section 37 of the Act and, in particular, the reference to the ability to meet these expectations, lay in the need to have some basis in the legislation to enable the power to make regulations for valuing liabilities, introduced in the same Bill, to go beyond provision for a company's contractual liabilities but to extend also to direct or indirect provision for future bonuses to with-profits policyholders.
>
> It is certainly true that the Instructions to Parliamentary Counsel for the 1973 Bill did draw attention to the desire to make regulations for valuing liabilities which included provision for making bonus expectations of with-profit policyholders and it was suggested that this extension of the concept of liabilities should be expressly spelt out in the Bill. However, a quite separate part of the Instructions on the Secretary of State's powers of intervention included the following:-
>
> Principal power
>
> The Department should have power to require a company to take such action as may appear appropriate to the Department to protect policyholders and potential policyholders of the company .... from 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 policyholders or potential policyholders.
>
> In the event the wording of this part of the instructions was, unusually, carried forward virtually unaltered into the Bill in what are now sections 37 and 45 of the 1982 Act but, possibly because this was done, Counsel saw no

> need to expand in the way suggested the regulation-making powers in what is now Section 90 of the Act.
>
> It is clear, therefore, that the ability to meet reasonable expectations was included in the 1973 Bill as grounds for the exercise of the powers of intervention in its own right and not merely as a peg on which to hang valuation of liability regulations which prescribe a standard above provision for a company's minimum contractual liabilities."

It appears equally clear from this insight in 1988 into the background to the Act that GAD had been proceeding for a material time on a false assumption about the scope of scrutiny that would have been appropriate. Regarding PRE as a peg for the valuation regulations would have led to the assumption that PRE was irrelevant except in so far as reflected in the valuation regulations.

108. Newton continued with helpful background observations:

> "Even if the "reasonable expectations" grounds had not been introduced in the 1973 Act as part of a package of measures designed to keep asset strippers away from the large free reserves held within life insurance companies (in particular to give teeth to what is now section 30), some such provision would sooner or later have become inevitable to match the changing nature of with-profits business.
>
> During the latter part of the 19th century and the early part of this century (the era reflected in the 1909 Act which effectively governed the conduct of life insurance business up to the 1973 amendments), the premium rates for with-profit contracts had been conventionally just 10% higher than for the corresponding non-profit contracts. Bonuses were distributed wholly in reversionary form so that the additional benefits built up more or less uniformly over the term of the contract. In the circumstances the bonus loading could reasonably be regarded as a small equity interest in the insurance company and if during the course the contract the company's treatment of its with-profit policyholders ceased to match up to their expectations, the policyholders were exposed only in regard to a very small part of their investment.
>
> The margin between the with-profit and non-profit premium rates has gradually widened over the years but in the middle 1950s, the earliest date for which returns are to hand in GAD, the differential was still only of the order of 20% - 25% for a twenty year endowment assurance. For some years now, however, the corresponding differential has been 70%, with non profit savings contracts almost ceasing to be a significant class of business. This has resulted from the effects of inflation which has taught policyholders the hard way not to rely on benefits fixed in monetary terms. The effect has been, however, wholly to change the character of a with-profits contract. I find it difficult to interpret a with-profit contract in current conditions as other than one where the policyholder entrusts the insurance company to do its best for him in the investment of his premiums and, in order to enable the company to invest heavily in assets such as property and equity shares which have performed well in the past but whose value at a future date is inherently uncertain, the policyholder accepts a guaranteed benefit representing less than half the return he can reasonably expect for his premiums.
>
> However, without any formula governing how the non guaranteed part of the return should be determined, there is clearly much scope for the inequitable treatment of policyholders, which is increased with the trend towards giving a very significant part of the return in the form of a terminal bonus when the policy matures.
>
> On this general analysis of the nature of a with-profits contract, you will see that we would fully support the view put forward in the draft submission that the policyholders' reasonable expectations are to share in the success or

> otherwise of the company's investment policy, and in any other sources of profit or loss, and not to any particular rate of return on their investment. Clearly a primary application of the reasonable expectation concept will be in relation to the apportionment of the distributed profits between policyholders and shareholders, as was originally intended."

These observations would have been significant at any time during the 1980s as the allocation of surplus between reversionary and terminal bonus shifted. They have particular significance as one approaches the 1990s when that process accelerated. GAD in particular were clearly aware of the need for legislation and regulations to take account of changing industry practice.

109. Newton continued on the issue of competent and prudent management:

> "We would also consider that the policyholder can reasonably expect that the company, and not just the funds, would be competently and prudently managed. In addition to the investment aspects, of which more below, this would cover the control of the expenses but should also include the company's rate of expansion where excessive investment in financing new business strain can lead to failure to meet reasonable expectations in regard to bonuses. Whether this is happening or not in a particular case is difficult to judge from outside the company and, here as elsewhere, the Department would presumable expect to intervene only in extreme cases and would be largely dependent on the company's Actuary.
>
> In practice the concept of prudent and competent management when applied to investment will come down largely to what degree of risk is considered to be in keeping with policyholders' reasonable expectations... However, even if the investment of a high proportion of the assets in a well spread portfolio of equities is regarded as in keeping with policyholders' reasonable expectations the concentration of a large part of the investment in, say, a single industry would clearly give rise to a risk that policyholders' reasonable expectations could not be met. However, quite apart from the problem of laying appropriate criteria, at present we do not even get the information to enable a situation which might not be in keeping with policyholders' reasonable expectations to be identified. In effect we rely on the AVRs and again on the role of the actuary within the company to control the situation."

110. Newton then discussed the development of non-profit business, before noting that the draft submission did not deal with whether reasonable expectations should extend to surrender values. He finished with a "general view" which advised caution:

> "Whilst we recognise the need for guide lines in regard to the policy to be applied in using the statutory powers of intervention on grounds of reasonable expectations, the particular situations to which I have drawn attention above do I believe illustrate the need for flexibility and the dangers in saying too much in public. There are a number of aspects where it would be difficult to maintain that reasonable expectations were not involved but where DTI in practice would presumably only wish to intervene in extreme cases. In some areas we do not at present have the necessary information and others where the powers could probably only effectively be exercised if more formal responsibilities are put on the Appointed Actuary."

111. On 1 August, Russell sent a revised draft of the submission to Newton. Newton again replied at length on 8 September. It is unnecessary to set out the terms of the paper in full. Russell's revised draft, at paragraph 13, had referred to problems associated with timing of receipt of relevant information and said:

> "But we and GAD are giving thought as to how the chance of such situations occurring can be minimised by giving greater definition to the role of the Appointed Actuary, and a more robust attitude to discipline by the .. Institute of Actuaries..."

Newton commented:

> "... as you may recall from Edward Johnston's notes and the discussion at the meeting on 20th July, the exercise of disciplinary powers by the actuarial profession is a more complex problem than may appear at first sight..."

and proposed that the subject be left over for a later paper.

112. Newton also commented at length on a new topic:

> "The discussion in the paper on reasonable expectations in regard to the distribution of surplus is largely confined to the apportionment of profits between policyholders and shareholders, but issues of policyholders' expectations also arise in regard to the respective treatment of different classes of policyholders. Whilst I recognise that there is a limit to the aspects of the question that can, or indeed need to be referred to in detail in a submission to Mr Maude, while the subject is under active consideration by officials I would draw attention to some of the main circumstances which may arise where the treatment of a particular groups of policyholders may amount to failure to meet their reasonable expectations, particularly as the number of cases where the Department is asked to intervene on these grounds could increase significantly in the future.
>
> It is not suggested that DTI/GAD should become involved in vetting the equity of companies bonus distributions as a matter of course. However, commercial pressures will always tend towards generosity in bonus distributions to those classes of policyholders where the company is competing most actively for new business and this may sometimes be carried so far as to prejudice the reasonable expectations of certain classes of existing policyholders. This has been a major issue in Australia where a number of companies have ceased to write traditional with-profits policies and the Commissioner in successive annual reports has expressed his concern that surplus generated from the older types of contract is being applied to increasing the rates of dividend on the new deposit administration type contracts that companies are currently marketing. The Australian Commissioner in one report went to far as to warn companies that if they did not mend their ways he might require the setting up of separate sub-funds in respect of the main classes of participating policies. Similar problems could arise in this country with the switch to "unitised" with-profits or the current emphasis on pensions as opposed to life insurance policies or, for example, where companies are ceasing to write IB business.
>
> The issue of policyholders' expectations may also be raised by changes to the form of bonus distributions. Although a particular bonus system, such as uniform reversionary bonuses may only do rough justice, it has generally been held in the industry that the method of distribution of surplus is part of the deal that the policyholder buys when he takes out his contract. Over the years virtually all companies have come to supplement their reversionary bonuses with terminal bonuses, which have gradually grown in importance with for some companies for longer term policies more than 50% of the total policy proceeds arising in this form.
>
> The use of terminal bonuses to distribute a part of the surplus can certainly be justified as the only method by which policyholders can be given a full share of the unrealised capital appreciation on the assets in which their premiums have been invested. However, from the company's point of view there are other advantages in terminal bonuses in that compared with reversionary bonuses the time when surplus funds are converted into additional contractual liabilities to policyholders is deferred, thus increasing the company's capital resources available, for example, for financing expansion. Increasing pressure on capital resources for some companies in the future could well lead to a situation where profits came to be distributed largely in the form of terminal bonuses, but in the extreme cases this could raise the question of

policyholders' expectations. The manner in which terminal bonuses are currently operated amount almost to a tontine system with benefits accruing disproportionately to the minority of policyholders who maintain their policies in force to the maturity date.

More generally, any sudden recasting of bonus scales can give rise to issues of policyholders' expectations. We have seen examples of increased in payouts on similar policies of the order of 30% or 40% as terminal bonuses have been introduced or greatly increased. Changes on this scale have certainly not added to the reputation of the industry or of the actuarial profession, since it is impossible to avoid the implication of very serious shortcomings in the basis for distribution of profits in the past, but there have generally been no actual losers and as far as we are aware the dissatisfaction that must be felt by policyholders whose contracts matured shortly before the increased has not been translated into formal complaints on grounds of reasonable expectations.

However in the circumstances likely to rule in the foreseeable future, significant realignments of bonus scales are likely to involve losers as well as gainers and the Department has recently had a difficult case where a policyholder has complained about a significant reduction in the maturity benefit under his pension policy compared with an estimate given by the company a few months earlier for no reasons other than, as the policyholder sees it, an arbitrary decision by the company to revise the shape of its bonus scales. Fortunately in the present instance the company can show that the new scale is more soundly based than the one it replaced, but were this not so an awkward question of policyholders expectations not being met would be involved.

Whilst we fully share the sentiment expressed in para 19 of the draft submission that we should not be overzealous in the pursuit of possible unfairness, for the reasons I have indicated I fear that there might be many more complaints to DTI in regard to bonus distributions in the future than there have been in the past. It is very much in DTI/GAD's interests that the initiatives of the Institute of Actuaries, following the discussion last January that you attended, should be effective in bringing about a more structured and consistent approach to bonus distributions than has always been applied in the past."

113. In the meantime the idea of legislation had been raised in DTI. The revised submission was sent to the Minister on 9 September. By way of background, it was stated:

"5. What is the purpose of reasonable expectation powers? If a policyholder buys life insurance without profit sharing he is protected by contract law. If however he buys a with profits policy at the cost of substantially increased premiums reflecting his participation in profits there was prior to the Insurance Act of 1973 no body of law, which protected his expectation that the increased premium would yield a reasonable return. His expectations were not covered by contract or by trust law.

6. The remedy taken were the powers to protect the "reasonable expectations" of policyholders in the Insurance Act 1973. However, ... very little was said publicly on how the Department should see its function under the powers, save that a with profits policyholder could reasonably expect substantially more than their contractual rights that there would be proper investment of their premiums, and that the reasonable expectations powers could be used to block a blatantly unfair change in the proportion of surplus allocated to long term with profit policyholders.

7. The Department's attitude to reasonable expectation powers needs clarifying in order to establish clear objectives for supervision, and to shape accordingly replies to complaints from policyholders whose insurance

> companies have cut their bonuses. Unless the Department's position is clarified there is always the risk that policyholders will want to put a very wide interpretation on the obligations of the Department to protect their reasonable expectations, and to argue that, we owe individual policyholders a 'duty of care' whereas we operate our powers in the general public interest. The Department could be subject to criticism if policyholders suffer severe bonus reductions because of a failure of the long term funds investment policy even though in every other respect the company has met all the requirements of the Insurance Companies Act and can say that policyholders' funds have been prudently managed. While investment returns have prospered there has been no particular reason to set out any limitations on what reasonable expectations means. But, ... we have now reached a point where it seems likely that the generality of life companies may have to reduce their bonus levels. In addition it is possible that some of the companies whose rates of return have been well below the industry average could come under pressure since under the best advice rules of the Financial Services Act regime genuinely independent intermediaries should not recommend their policies. This could reduce yields further if they do not realign their cost structure quickly enough."

114. The paper then set out the areas in which policyholders' reasonable expectations were thought to be problematical. Investment returns were mentioned. The concept of prudent and competent management was discussed. The problems of enforcement where there was perceived slippage in the quality of investment management were set out. Problems associated with transfer of undertakings were discussed. There was a risk of greater consumer awareness, and an increase in complaints. The paper then identified the 'gap' in the legislation:

> "19. At present there is a gap in our powers through some faulty drafting of relevant sections in the Insurance Companies Act. Our powers of intervention under reasonable expectations apply where there is a risk that a company may be unable to fulfil the reasonable expectations of policyholders or potential policyholders. There could be situations where a company can demonstrably be able fulfil reasonable expectations but chooses not to. It is desirable that this gap should be closed by a small drafting amendment deleting the reference to ability ..."

115. The paper recommended that:

> "The Department should continue to use the powers in the Insurance Companies Act to ensure that:
>
> a Policyholder funds are properly managed in accordance with their interests and in particular that the balance of distribution and profit between shareholders and policyholders should be equitable with no significant departures from past practice, without good cause.
>
> b. Policyholders funds are administered prudently and the level of skill and competence should not depart excessively from the range which it would be reasonable to expect from the company concerned in all the circumstances of the case. However as a matter of law the Department does not consider that policyholders can or should have reasonable expectations of any particular rate of return as such.
>
> c. The company does not engage in practices which are obviously unfair. For example the sales effort and promotion of a company should not give a picture to potential policyholders which the company knows or should know at the time is unlikely to be fulfilled.

d. No comprehensive statement of the criteria for the use of reasonable expectation powers should be made but there might be advantage in speaking selectively on certain aspects.

e. We should close through legislation the present gap in our reasonable expectation powers..."

116. The Minister's private office responded on 20 September 1988 indicating that the Minister would like to discuss the substance of the submission on his return from a trip abroad, but also that he did not regard the subject as a high priority for legislation.

117. In February 1989 matters became case-critical. There was a dispute over the respective interests of policyholders and shareholders in the assets of a certain life company. The details of the dispute are not material, but the company submitted an opinion by Patrick Howell of counsel that discussed 'reasonable' or 'legitimate' expectations in the context of his review of administrative decisions as some support for what one would expect in any event, "namely that expectations involve something wider than enforceable rights or liabilities, and that statements or previous practice which do not create actual liabilities may nevertheless give rise to expectations". Internal legal advice supported Howell's approach.

118. In March 1989 a proposed renewable term assurance contract caused problems in the case of another life company. Policyholders' reasonable expectations were discussed in preparing the department's response to the company:

> "11. GAD and DTI are already under pressure from [the company] and its actuary to indicate what we would find acceptable. I think you should say that the policyholders' reasonable expectations will depend on precisely what is said to him at the point of sale and how the contract is sold. That this needs to be consistent with the company's intentions, that the reserving basis needs to ensure that these intentions can be carried out, that since these three aspects are so interdependent it is for the company to make proposals which DTI can then consider."

It was thought that that would provide a breathing space for the department to consider what policyholders' reasonable expectations were in the circumstances. A benchmark was required for other companies expected to bring forward similar proposals.

119. As anticipated, there were complaints about the performance of particular funds, related to property-linked assurances, and the incidence of losses on mortgage business, in addition to an increasing flow of issues relating to allocation of surplus assets. On 25 June 1993 comprehensive instructions were prepared for submission to counsel for advice on action that the department might take in relation to the mortgage losses case. The instructions made reference to opinions issued by Stanley Burnton and Jonathan Sumption QC with Bill Charles (of which more below). The legal issues were well focused.

120. On 9 July GAD issued a 'dear appointed actuary' (DAA) letter and survey form to the appointed actuaries of "leading UK offices transacting with-profits business". The letter noted the growing debate within the life insurance industry over how to assess the most appropriate method for the distribution of surpluses arising in the long-term funds of with-profit offices, and the development of new methodologies for this purpose, including "the technique known as 'asset shares', although there is no clearly accepted definition of how these asset shares are calculated". The survey sought detailed information on bonus philosophy, the marketing literature, and the actual methods and rationale by which rates of final or terminal bonus were determined.

121. Of the specific questions proposed, it is necessary to refer to one only. In the first part of the questionnaire there was a question:

> "Is there any reference in the literature/ product particulars to the following:

...

(d) Any charge levied for the guarantees provided to policyholders in respect of payments on maturity of basic policy benefits plus previously declared bonuses?"

122. The DAA letter and survey illustrate departmental thinking on a number of issues at this time. Although PRE was an area of significant interest, the expression was not mentioned. A deliberately neutral tone was adopted. The term 'asset share' was treated as an aspect of a range of novel methodologies that remained undefined. There came to be tendency to use the expression as if it were of known meaning. But it is clear that at July 1993 GAD's view was that it did not have an acknowledged meaning in the profession. The letter also indicated acceptance that the regulatory returns did not disclose the information required to inform regulators and GAD of facts and circumstances bearing on the issues raised. The acknowledgment of this deficit is important in pointing to an overall lack of relevant information at crucial times in the developing scene. Interestingly, as noted above, information was sought on charging for accrued guarantees at maturity. GAD were aware at this relatively early stage that there could be issues related to practice in this area.

123. On 21 July GAD prepared a background report relating to the proposals of United Friendly for allocation of profits to shareholders. The note set out some historical background material on the development of with-profits business. It discussed the development of investment policies, life fund accounting, the development of the bonus systems, surrender values, policyholders' reasonable expectations, and the allocation of profits between shareholders and policyholders. In relation to policyholders' reasonable expectations, the paper noted:

"6) Policyholders reasonable expectations.

6.1. Although central to current thought on profit distribution, this concept is not specifically defined, and ultimately can only be interpreted pending testing in the Courts.

6.2. Common sense suggests that, at least in respect of their own class of business, with-profits policyholders should share in any mortality profit (or loss) arising in respect of their experience. Similarly participation in the actual out-turn of expense experience, relative to that assumed in the calculation of the premiums, and of the excess investment return achieved relative to that assumed (including both realised and unrealised capital appreciation in respect of the investment attributable to the long-term fund) seems appropriate.

6.3. The actual treatment of miscellaneous items of surplus (in accordance with policyholders reasonable expectations) is much less clear-cut, and largely depends on past practice and any information conveyed to policyholders in various ways at different times in the past. With-profits policyholders of many offices have, until now, always participated, at least in part, in surrender surplus from their own class of business, and in total profits from non-profit classes. The elimination of future surrender profits due to improvement in the amount payable to those policyholders surrendering policies appears reasonable. However, any diversion of non-profit surplus from policyholders to shareholders without compensation for the entitlement being given up would raise questions about whether the reasonable expectations of with-profit policyholders can still be met...."

Annex ...

"1) Background information

1.1 In the early days of life assurance, some 150 years ago, contracts were issued on the basis of fully guaranteed terms. Those offices which, in the light of subsequent experience, were found to have charged inadequate premiums

ceased to exist – unless some benefactor gave them a second opportunity by means of a sufficient cash injection to rectify the situation.

1.2 Consequently the survivors were those offices which, with the benefit of hindsight, had charged "adequate" – which in practice often meant "excessive" – premiums to cover the risk. In order to be seen as secure, competitive and fair to policyholders, the practice developed of making non-contractual additional payments to policyholders at the date of claim in the form of a bonus which was determined in the light of the experience (ie very broadly reflecting the profitability of the business.)

1.3 When first introduced this bonus was only guaranteed for periods of up to one year at a time and was referred to as a "mortuary" bonus, although it was usually paid on maturity of endowment policies (albeit that such contracts were then relatively rare) as well as on death. With increasing confidence in predicting likely future experience, together with an expansion of the volume of business in force (which reduced the risk of significant fluctuation in experience) the period over which such mortuary bonuses were guaranteed (in respect of business in force at the declaration date) was extended. Eventually the bonus addition declared each year became the guaranteed reversionary bonus as we know it to-day (ie a bonus added to the basic policy benefits, guaranteed once declared and payable whenever in the future a claim arises).

1.4. In the early years of the twentieth century a need was perceived for differentiating contracts, at issue, between those 'non-profit' policies where the policyholder wished to pay the minimum premium commensurate with a guarantee of specific benefits, and those 'with profit' policies where a somewhat higher premium was levied relative to the basic guaranteed "sum assured", but bonuses could also reasonably be expected to be provided dependent on experience.

1.5. Premiums for non-profit contracts are calculated on mortality, interest and expense assumptions which are considered suitably cautious, but not excessively so, with an additional "contingency loading". In the case of with-profits policies a specific bonus loading, often at a rate of about one-half of that which the office hopes to declare, is added to the basic premium otherwise calculated on similar assumptions to the non-profit contracts.

1.6 Traditionally, the offices invested mainly in fixed-interest securities, loans and property and a key risk borne by the office was that the interest rate available on future investments would be less than that assumed in the premium bases.

1.7. Therefore for most offices the assured benefits under non-profit contracts were effectively guaranteed by the with-profit policyholders in so far as it is their bonuses which are at risk in the event of adverse experience in respect of the former contracts. In return they not unreasonably expect to share in any profits emerging from the transaction of the non-profit business. In the rare event that shareholders had put up all the capital needed in order to write non-profit business (which is of course necessary where there are no with-profits contracts to underwrite the risk) then it would be reasonable for the shareholders to take all the profits (and any losses) resulting from this class of business.

1.8. Since about the 1950s, equities have become progressively more worthwhile as an investment which has provided a better although more volatile rate of return than fixed-interest securities and loans, especially in a high inflation environment. Therefore, in order to provide a competitive rate of return by way of bonuses, offices have gradually shifted their investment portfolios so that these now generally contain a very high proportion of equity investments.

1.9. This has led to a development of the underlying philosophy, whereby the with-profit policyholders are now regarded as providing some of the capital or free reserves (through payment of higher premiums than the non-profit policyholders), which allows the office freedom to invest in equities and still be sufficiently confident of meeting all the guaranteed liabilities on its contracts, even in the event of any fall in the market value of its assets.

1.10 As a consequence of this development, it is also possible to regard the writing of other non-profit or unit-linked business as an investment activity which is supported at least in part by the with-profit policyholders.

1.11. However, in the last thirty years or so, many new offices have been set up solely to transact unit linked business (which is a special type of non-profit contract) and clearly all the profits belong to the shareholders who have subscribed the capital and take the attaching risks.

1.12 Most traditional with-profits offices have subsequently followed into this market. Many of these offices would share the profits on this business between with-profit policyholders and shareholders as explained above. However, where the shareholders subscribed all the necessary capital for the transaction of this linked business and consistently borne any losses resulting from this type of business, and where also it has throughout been made clear to policyholders that 100% of the profits/losses would go to shareholders, then there can be no valid objection from with-profits policyholders resulting from their non-participation.

1.13 Somewhat more unusual, but not unknown, is the situation where the with-profits policyholders have effectively borne the losses whilst the linked business was unprofitable, and this was subsequently amended retrospectively (and maybe the Articles simultaneously clarified) with a compensatory adjustment for with-profit policyholders when the linked business eventually turned profitable. The resulting future profits on the linked business were then made available to shareholders.

2) Life fund accounting

2.1. The Insurance Companies Act of 1973 introduced the concept of the "long-term fund". This fund comprises all the income less expenditure properly attributable to long-term insurance contracts including the investment income and gains relating to the assets built up within this fund. Transfers from this fund can only be made out of any surplus declared following a (published) valuation by the appointed actuary on a basis which complies with specified minimum actuarial standards.

2.2 The Valuation of Liability Regulations effectively prescribe the methods and assumptions by which the value of the liabilities in respect of long-term insurance contracts will be determined. Full allowance is made for all guaranteed policy benefits including previously declared reversionary bonuses. However, only partial provision is generally made for future discretionary bonuses that policyholders may reasonably expect.

2.4. Assets are valued on a Market Value basis, the excess over the value of the liabilities being referred to as the "investment reserve". This effectively consists largely of (i) realised capital appreciation on investments which has not yet been taken into the revenue account, (or profit and loss account) and (ii) unrealised capital appreciation, both of which may be utilised to provide future bonuses for policyholders.

3) Reversionary bonuses

3.1. Traditionally, reversionary bonus was (and generally continues to be) determined as the rate of bonus which could be paid out of revenue surplus. The concept of "smoothing" payments to with-profits policyholders, in order to minimise the fluctuations from year to year, resulted in a measure of transfers

to or from the investment reserve, dependent on the size and sign of non-recurrent items of surplus (profit) emerging in a particular year.

3.2. Initially usually "simple" in form (ie paid only on the sum assured) reversionary bonuses gradually developed into "compound" bonuses (payable additionally on existing bonuses – which advantages the longer term contracts), and more recently to "super-compound" (with a higher rate payable on existing bonuses than on the sum assured) which is even more favourable than compound to longer term business. This latter device has been extremely useful to actuaries in achieving a reasonable balance between the returns due on long-, medium- and short-term policies.

3.3. The transfer of surplus to shareholders has always been determined relative to the cost of policyholders bonuses on the published valuation basis. Where shareholders receive exactly 10% of distributed surplus, this is equivalent to one-ninth of the total cost of such bonuses.

4) Development of Terminal bonuses.

4.1. The concept of terminal bonuses was devised in the 1950s, and was originally envisaged as a temporary means of distributing equitably profits which had arisen from either capital appreciation on equities or exceptional dividend payments received on the company's investments. The scales adopted initially were extremely broad brush in approach. With the passage of time it became clear that such profits were not quite the temporary phenomena originally envisaged and attempts were made to refine the rationale and scientifically improve the underlying numerical approach

4.2. The simultaneous expansion of the market in unit-linked contracts led to the development of what has come to be known as the "asset share" approach to determining an equitable pay-out under with-profits policies. Conceptually this entails accumulating, at an appropriate rate of interest, (relating to the investment return achieved on long-term assets) the actual premiums received, net of expenses incurred, and with suitable allowance for mortality. The result of this calculation is then adjusted for any miscellaneous surplus arising (eg from non-profit business, discontinuances etc) before being reduced to reflect the cost of shareholders transfer in the case of a proprietary office. An adjustment factor enters into the calculation reflecting the period (often up to five years) over which the actuary aims to smooth his with-profits pay-outs.

4.3. Conceptually the approach is sound. However, its practical application is made much more difficult by the absence in many offices of reliable historical data about rates of investment return, expenses, and surrender profits (see Section 5). This may permit some offices to claim to be giving "value for money" although they are in reality holding back significant amounts of surplus within the long-term fund.

5) Surrenders

5.1. In the early years of life assurance, surrenders were not payable on discontinuance at any duration. Gradually the practice increased of paying values which, even allowing for the front-ended expenses incurred, and the mortality risks borne, could hardly be described as generous. This reflected the view which to some extent still prevails to-day that the amount payable on surrender should be determined so as to include a penalty for premature discontinuance, irrespective of the reason why the contract is being discontinued early.

5.5. There is now, however, a trend towards the granting of higher surrender values, many offices moving to an asset share approach (which is regarded by most actuaries as an appropriate benchmark, provided the parameters used are appropriate). Any such move, while benefiting policyholders who surrender early, obviously entails disadvantages for those continuing policyholders who

previously participated in the profits arising in respect of surrendered contracts.

6) Policyholders reasonable expectations.

6.1. Although central to current thought on profit distribution, this concept is not specifically defined, and ultimately can only be interpreted pending testing in the Courts.

6.2. Common sense suggests that, at least in respect of their own class of business, with-profits policyholders should share in any mortality profit (or loss) arising in respect of their experience. Similarly participation in the actual out-turn of expense experience, relative to that assumed in the calculation of the premiums, and of the excess investment return achieved relative to that assumed (including both realised and unrealised capital appreciation in respect of the investment attributable to the long-term fund) seems appropriate.

6.3. The actual treatment of miscellaneous items of surplus (in accordance with policyholders reasonable expectations) is much less clear-cut, and largely depends on past practice and any information conveyed to policyholders in various ways at different times in the past. With-profits policyholders of many offices have, until now, always participated, at least in part, in surrender surplus from their own class of business, and in total profits from non-profit classes. The elimination of future surrender profits due to improvement in the amount payable to those policyholders surrendering policies appears reasonable. However, any diversion of non-profit surplus from policyholders to shareholders without compensation for the entitlement being given up would raise questions about whether the reasonable expectations of with-profit policyholders can still be met...."

The remainder of the paper dealt with the 90:10 split.

124. The paper (largely the work of William Hewitson, who would become the directing actuary in 1997) appears to present, in a relatively summary way, GAD's perspective on the historic development of bonus practice. In relation to PRE, the distinction drawn between elements of value related to 'assets share' and other elements, the latter only being related to past practice and communications, reflects a view that had begun to develop widely among actuaries.

125. PRE was becoming an issue in the profession and industry, particularly with reference to the allocation of surplus assets. A memo sent by Roger Allen, the head of the life insurance department within the insurance division at DTI, to Hewitson on 25 November 1993, illustrated this in which he reported a discussion with representatives of an investment bank. Responding to a suggestion that DTI did not regard current policyholders as having any claim over built up surpluses, Allen said that he had given the company "a pretty frank and thorough account" of the current view of the regulator on PRE:

"I explained that we would take into account what a company had said about allocation of bonuses in its articles or marketing literature; its actual practice; and practice within the market as a whole..."

Regulators saw a need to establish some general principles to guide individual decisions, while being cautious about fettering discretion.

126. GAD had wider interests. In a minute sent by Michael Pickford, directing actuary for life business at GAD, to Jonathan Spencer, head of insurance directorate at DTI, on 15 February 1994, the other aspect of the issue was discussed: shareholders' interests. Pickford stated:

"The number of issues which arise from considering the concept of shareholders' interest in the long-term fund is huge..."

He highlighted incidence of mis-selling liabilities as between the long-term fund and shareholders' interests in proprietary offices, and the parallel problem in mutual offices. This became a topic of interest, and much discussion, in the case of proprietary offices. In the case of mutuals the interest related to the incidence of liabilities among different classes of business.

127. On 10 March 1994 Allen wrote a memo to Spencer setting out the position as he saw it, in advance of a meeting to discuss policyholders' reasonable expectations:

> "I agree that we need to establish some principles against which we can judge the different cases. We need this both to help us deal with the question of compensation for pensions mis-selling, and to help us address the question of "orphan estates". I am not yet clear how far we can go in establishing principles which will be of practical use in both types of case; it may be more helpful to develop two sets of guidelines, based on some very general common principles.
>
> So far as orphan estates are concerned, we already have a fairly well-developed theoretical basis as to what constitutes policyholders reasonable expectations, ...[11], (in brief, PRE is derived from a number of factors, notably published information about a company's policy; the actual custom and practice of the company; and normal market practice. But we still have a long way to go to convert these general principles into arrangements which can be agreed with individual companies.
>
> ... (B)ased on Counsel's advice... PRE may go beyond contractual or proprietary rights; it includes an expectation as to the manner in which the business of the company will be conducted; and the balance between policyholders and shareholders should not, in any substantial respect, be altered in a manner adverse to policyholders. ... These principles may be applicable to all types of case we are considering..."

He believed that the department should publish guidelines.

128. Following the meeting Allen prepared draft guidance on PRE. One of his team, who was senior line supervisor for Equitable at this time, responded with two memos on 18 and 24 March. He thought that regulators and GAD were not in a position to draft general policy guidelines without counsel's opinion on the incidence of liabilities for mis-selling and other irregularities. He drew attention to the position of mutuals: it might be appropriate to immunise policyholders from charges to their asset shares in cases where there was a reasonable estate, but:

> "What happens for example where there is no estate to speak of? (Equitable might have this problem but for their absolute assurance that it is inconceivable that they have mis-sold a single policy)."

The incidence of liabilities in mutuals was considered. There was a question whether they should fall on all 'members', or with-profits policyholders only. The senior line supervisor's second memo suggested that it would be relatively straightforward to "knock up" general guidance on distribution of profits based on a then current case, when it was completed. But overall, he considered that more work was required before general guidelines could be produced. The department continued to have to deal with new practical problem situations, and develop its approach to PRE accordingly.

129. Discussions continued on the preparation and publication of guidance through the spring of 1994. The areas of particular interest on which the work was concentrated related to proprietary companies. Officials were concerned about the allocation of costs, fines and compensation as between shareholders and the with-profits fund, and on the respective interests in 'orphan' estates. As the Brindley report showed there had been experience of treatment of orphan estates, and a more

[11] Set out in a letter to United Friendly dated 16 November 1993.

developed methodology had emerged in that context. Shareholder interests tended to be concentrated on the release to the proprietors of the company of surpluses brought forward, to the exclusion of policyholders. The Department frequently found itself in confrontation with companies' legal advisers asserting the shareholders' right to all or substantially all of the 'orphan' or 'free' estate on the basis that policyholders' rights to participate were conditional on the exercise of directors' discretionary powers. Of necessity the Department's response involved asserting the policyholders' reasonable expectations of participating in the office's undistributed funds.

130. The issue of fines and where the cost should fall was also current. This arose because of allegations of widespread mis-selling, especially of pensions business, and the imposition of penalties by the Securities & Investments Board (SIB), along with claims for compensation by those adversely affected. If the entity that was liable could not pay, and there was a claim under the compensation scheme established in terms of section 54 of the Financial Services Act 1986, on whom should the cost of the levy fall? Regulators tended to take the view that responsibility for mis-selling lay with management, which was a matter for shareholders rather than policyholders. In the case of mutuals, there was no alternative but to charge fines, compensation and levies against the long-term fund. The significance of the liabilities lay in their potential to cause real transfers of economic benefit among policyholders. Compensating one group of policyholders, the 'victims' of mis-selling practices by the office's management, could only be at the cost of other groups of policyholders.

131. In the case of surpluses, the issue for mutuals was as to the balance of interest over generations of policyholders. With fines the issue concerned different classes of policyholder. In both cases issues that have arisen in the Equitable case were clearly anticipated in these discussions.

132. On 20 June 1994, Hewitson took up the issue of orphan estates in a memo to Allen. He wrote:

> "In determining the proper attribution of an orphan surplus or estate for a proprietary with-profit life office, our judgment is heavily influenced by the concept of PRE. Therefore any guidance note on this subject would need to deal with our interpretation of PRE in the above context.
>
> I believe that the note would then include reference to the following points relating to the distribution of profits that may be significant. The precise list of factors influencing PRE and the weight to be given to each of them will though depend on the circumstances of each office.
>
> 1. Past representations to policyholders, advisers, SRO's and DTI (including marketing literature, policy conditions and with-profits guide.
> 2. Articles of Association.
> 3. Statements in DTI returns (or other public documents)
> 4. Past custom and practice of company
> 5. Identification of sources of accumulated surplus (including any direct contribution to the long-term fund by shareholders)
> 6. Ability to maintain reasonable level of payouts in changing investment conditions (after potential removal of any surplus attributed to shareholders)
> 7. Immediate impact on relative payments over next few years.
> 8. Perceptions of balance of interest between policyholders and shareholders.
>
> We could then provide a short narrative, perhaps with hypothetical examples as a helpful steer to most companies without defining precisely all the relevant parameters and explaining why each of these factors could be relevant.

> Overall, the note would signal clearly to companies (and predators!) that DTI were now willing to consider requests for allocation of at least part of any orphan surplus in the long-term fund wholly to shareholders."

133. There is little in Hewitson's note that could not have been written twenty years earlier. It omitted reference to wider industry practice. But in other respects it was fairly comprehensive. What is perhaps remarkable is that a provision that had received the blessing of Parliament in 1973 had not received similar attention before, and that it should be treated at this stage as if it were relatively novel.

134. The developing thought gave rise to a 'working rule' that part of the estate of a proprietary company that had arisen from 'under-distribution' was deemed to be attributable to policyholders and shareholders in the respective proportions in which distributed surpluses were divided at the time the under-distribution arose. The application of the working rule was treated as a PRE issue. The working rule gave rise to controversy with actuaries. DTI and GAD began to think that legislation would be required. On 11 July 1994 Allen wrote to Pickford about future primary legislation:

> "One possibility, which we have not yet discussed in any depth, is legislation to clarify the position on Policyholders' Reasonable Expectations. We need to consider more precisely what we want to achieve in this area, and then consider the best means to achieve it (which might be legislation, but could be, eg guidance).
>
> As I believe it was you who first floated the idea of legislation on PRE, could I ask you please, as a first step, to set out the problem as you see it, and your proposed solution?"

135. On 18 July Allen distributed an extract from the presidential address delivered to the Institute of Actuaries by the Government Actuary, Christopher Daykin. Daykin's views included:

> "The appointed actuary of a life insurance company has a professional duty under GN1 to have regard to the reasonable expectations of policyholders. This highly actuarial phrase first appeared in legislation in the Insurance Companies Act 1973 as a ground for intervention by the Department of Trade and Industry, having been coined by Ronald Skerman in his paper to the Institute on the five principles of valuation. The meaning of the words has yet to be tested in the courts and debate has raged in the actuarial profession over what is envisaged. Part of the strength of the relevant DTI power lies in the uncertainty – the actuary can use this to good effect in adopting a professional approach to ensuring equity and value for money for the policyholders."

Allen was not impressed by the view that uncertainty continued to be a virtue in the contemporary world. He thought that greater clarity would be in everyone's interests. But the view was held by and exploited by GAD. It has been explained that no-one knew whether the gun was loaded: it was made clear that it was carried and provided a necessary level of threat.

136. Whatever the expression 'highly actuarial' was intended to mean, Daykin's comments did not reflect the historical record, even if Skerman's inspiration had been relied on by Cyril Homewood when he proposed the original draft clause. What the statement did confirm, however was that there had not been a well-developed critique of the expression in actuarial circles over the twenty years that it had been on the statute book.

137. Allen wrote to Spencer on 12 September 1994 encouraging the publication of guidance. Meanwhile individual companies continued to approach the department for guidance in relation to the handling of their own business. The impending resolution of one long-standing problem relating to the affairs of United Friendly Insurance plc gave Allen the opportunity to propose an arranged parliamentary question (PQ) and statement on the Department's attitude to the general issue of the

orphan estates of proprietary life offices. It was not until 17 February 1995 that the question and answer were finalised following legal advice.

138. The PQ was:

> "Q. To ask the President of the Board of Trade what is his Department's attitude to the balance between policyholders' and shareholders' interests in the long-term funds of life insurance companies.

It was answered by the Consumer Affairs Minister, Jonathan Evans, on 24 February 1995 as follows:

> A. A number of with-profit life offices have accumulated amounts within their long-term funds whose allocation between shareholders and policyholders may not be clear-cut; and there has been a growing interest among relevant companies in the scope for clarifying shareholders' interest in the long-term fund.
>
> The Department is in principle in favour of greater clarity in the attribution of the long-term funds of proprietary insurance companies. In any such attribution, it has a responsibility to ensure that the reasonable expectations of policyholders are fulfilled.
>
> The Department considers that policyholders' reasonable expectations in respect of attribution of surplus are influenced by a range of factors, notably:
>
> i. The fair treatment of policyholders vis-à-vis shareholders;
>
> ii. Any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profits, eg. In its Articles of Association or in company literature;
>
> iii. The history and past practice of the company;
>
> iv. General practice within the life insurance industry.
>
> The department is concerned that any restructuring of funds for the purpose of clarification should preserve a proper balance of interests as between policyholders and shareholders. In this connection, it considers that the proportion of policyholders' and shareholders' interests in the surplus are unaffected by whether or not the surplus is actually distributed – that is, if in any year surplus is not distributed but is retained in the fund, the policyholders as a class retain their interest in that element of the fund.
>
> A life office may make distributions from surplus in the ling-term fund as shown by the statutory annual actuarial valuation. It is common practice to make distributions to policyholders and shareholders in the proportion 90-10. In assessing policyholders' reasonable expectations, the Department would expect this ratio to be used as the basis of attribution between policyholders and shareholders, unless there was clear evidence, based on a company's circumstances, statements or practice, that a different proportion was appropriate in respect of the surplus arising from some particular part on the business.
>
> The Department considers that the proposal announced today by United Friendly Insurance to restructure its long-term funds is consistent with these principles. It has reached this view on the basis of information provided about the history and practice of the company, the amount of accumulated reserves to be set aside for the benefit of with-profit and other policyholders (a part of which is being used immediately to declare a special bonus to policyholders), and the intended arrangements for the future distribution of surplus arising in the long-term funds.
>
> The Department will assess any similar proposals from other life offices having regard to the facts of the case and the principles described above. The outcome

in any specific case will depend on the history and circumstances of the fund, which may differ widely from company to company."

139. In anticipation, officials had been attempting to develop a more general rationale for the approach to orphan estates. Hewitson prepared a set of questions and answers to focus issues. His definitions did not meet with immediate agreement and threw up an issue whether the importance attached to holding orphan estates was compatible with regulators giving approval to their release to shareholders. There was no clear view on the basic approach to adopt apart from the limited statement in the answer to the PQ. Allen circulated a draft paper on 4 April 1995. Among other issues raised in the initial stages of the responses were the need for a legal analysis, the risk of conflict of interest of the appointed actuary, and the requirements stemming from the Code of Practice on Open Government.

Counsel's advice to DTI on PRE

140. Over a number of years the DTI had sought counsel's advice on issues relating to policyholders' reasonable expectations. On 8 January 1987 Sumption and Charles (see above) advised that a policyholder would reasonably expect (i) that the company's investment policy would be prudently formulated and applied with the object of maximising the long-term returns; and (ii) that the balance between policyholders in different classes would not in any substantial respect be altered in a manner adverse to any class of policyholder. It followed, on their advice, that a policyholder would reasonably expect the company to obtain the true market value of an asset it disposed of and not expect the company to give assets away. They also advised that a scheme would be contrary to reasonable expectations if policies had been marketed on a basis with which it was inconsistent.

141. On 8 February 1989, Howell advised on the shareholders' proportion of surplus[12]. He stated that expectations might be based upon some statement or undertaking; or on an express promise; or arise from the experience of a regular practice which gave rise to a legitimate expectation based upon that practice. He said that whether expectations were reasonable had to be mainly concerned with the fact that premiums on with-profits business were considerably higher than the amount needed to cover mortality risks and guaranteed sums. He advised that it would plainly be unreasonable for a company not to declare bonuses, but to "raid" the bonus reserve for management expenses; or for financing excessive levels of new business to benefit shareholders or future policyholders; or in ill-matched investment projects to produce a bonanza many years later with a severe reduction in returns in the meantime. He said that an office adopting investment or bonus practices which put at risk reasonable levels of bonus for current policyholders would be open to intervention under then Act.

142. On the other hand, Howell stated that a departure from previous practice would not amount to a failure to fulfil "reasonable expectations" provided that (a) no specific expectations had been raised to the contrary; and (b) the result did not to deprive policyholders of rights. Again, he said: "policyholders ... cannot ... have ... an expectation that the estate will be maintained at any particular level ... above what is needed to provide for solvency and ... bonuses, with a suitable margin for contingencies", and: "Nor ... can one generation ... reasonably expect that excess funds held within an estate will be released to provide windfall bonus allocations".

143. In conference, counsel agreed with a list of factors influencing policyholders' reasonable expectations set out in instructions dated 5 April 1993:

- General principles of bonus distribution set out in the marketing literature and policy documentation of the office;
- Representations made at point of sale;
- Company practice followed in previous years;

[12] See paragraph 117 above.

- Industry practice as generally understood through media commentary;
- Detailed descriptions of bonus philosophy given in the office's with-profits guide, complementing information in marketing literature or policy documents about individual products;
- The general perception that, in return for higher premiums, with-profits policyholders would benefit from profits of long-term fund, particularly from investment return earned by the office;
- Normal industry practice that reversionary bonus rates were altered gradually (except in exceptional circumstances) and that final bonuses are smoothed; and
- The belief that policyholders would be treated fairly vis-a-vis shareholders.

A note of conference with counsel in November 1993 stated that there was little common ground within the market on the distribution of surplus between policyholders and shareholders.

144. Instructions to counsel for the United Friendly case in 1995 were reflected in the subsequent PQ answer. They stated that policyholders had: "an expectation that they will receive a proportion of any distribution of surplus (in the form of bonuses declared by the directors)"; and that counsel had previously advised that reasonable expectations went beyond contractual or proprietary right. Relevant factors included past practice of the company, written or oral statements, and industry practice as understood through media commentary. Policyholders' reasonable expectations related not only to bonuses but also to the expectation that the distribution of profits (between shareholders and policyholders) would not be altered substantially to their disadvantage and would remain broadly in line with industry practice. Further, a company might retain sufficient surplus to ensure appropriate investment freedom and business development. It would be contrary to policyholders' reasonable expectations to build up an estate and distribute it to shareholders from time to time. If the company reduced the accumulated surplus, policyholders should receive a proportion commensurate to the amount that could have been distributed in the past rather than retained (90:10). The instructions also noted that the regulator's view of policyholders' reasonable expectations was not universally accepted within the industry.

145. Alison Burke, a departmental solicitor, prepared a draft summary of the legal advice the Department had received on policyholders' reasonable expectations and circulated it on 11 April 1995.

> "Under sections 37 to 45 of the Insurance Companies Act 1982 (the "Act"), statutory powers of intervention become exercisable in relation to any insurance company to which Part II of the Act applies if the Secretary of State considers their exercise to be desirable for protecting policy holders or potential policy holders against the risk that the company may be unable to fulfil their reasonable expectations. The meaning of "reasonable expectations" in sections 37(2)(a) and 45(1) had been the subject of some consideration – no definition appears in the Act.
>
> 1. The Act contrasts a "reasonable expectation" of policyholders with the company's liabilities. Policy holders may have a "reasonable expectation for the purposes of the Act, notwithstanding that the expectation goes beyond enforceable legal rights.
> 2. It is irrelevant what are the subjective intentions of a particular policyholder or even the generality of policyholders. The "expectations" in question are those of a large fluctuating body of persons whose subjective intentions are likely to differ. Further the "expectations" include those of potential policyholders who can by definition have no relevant state of mind about the affairs of the company. The word "reasonable" imports an

objective test – a "reasonable expectation" is the expectation which a hypothetical reasonable policy holders would have.

3. The hypothetical policyholder may have an expectation as to the manner in which the business of the company will be conducted, notwithstanding that the generality of policy holders are wholly ignorant of the relevant facts. If this were not so, then:

    (i) the Secretary of State would be unable to exercise, on the grounds stipulated in sections 37(2)(a) of the Act, any of his powers under sections 38 or 41 to 45 if the information on which he was acting was not available to the generality of policy holders; and

    (ii) a company would be the less amenable to regulation the more secretively it behaved. The question whether intervention under the Act is justified to protect PRE does not necessarily depend on the information available to policyholders, but depends on the information available to the Secretary of State at the time when he takes the action in question.

4. Action by the company would certainly be contrary to the "reasonable expectations" of policyholders if their policies had been marketed to them, (or to a significant number of them) on a basis with which it is inconsistent.

5. PRE not only relates to the amount of any bonuses declared for the benefit of policyholders. A hypothetical policyholder would also reasonably expect that the balance (i) between shareholders and policyholders and (ii) between policyholders in different classes, would not in any substantial respect be altered in a manner adverse to the policy holders (or any class of them). The word "adverse" is intended to refer to the balance of interest between the groups referred to and not only to the anticipated return of the policyholder before and after the relevant transaction. Policyholders (or some class of them) may, therefore, be adversely affected even though they will be better off after the relevant action has been taken by the company, if the facts are that they would have been better off by a larger margin had the balance of competing interests not been disturbed.

6. The following factors are relevant to the determination of PRE in any particular case:

    (a) past practice of the company;

    (b) written or oral statements made by the company, at point of sale, in marketing literature, policy documentation, with-profits guides etc.; and

    (c) industry practice as understood through media commentary."

The note ended with a discussion of the treatment of 'orphan estates' in proprietary companies.

146. There followed a protracted correspondence and exchange of views between DTI and GAD in which differences of opinion emerged as to what had been done in the United Friendly case, and as to the implications for future policy. These exchanges did not challenge Burke's analysis of the legal advice the department had received. Hewitson extended considerably the sources of evidence that might be relevant in particular cases. The detailed discussion of the need for independent actuarial advice, and for its publication, and the possibility of conflict of interest affecting the appointed actuary, in decisions on the respective interests of policyholders and shareholders in orphan estates is not relevant for present purposes except in so far as it reflected general views of PRE. As already mentioned, in Spring 1995 the Life Board Research Committee set up a working party on

'orphan estates'[13]. John Rathbone, chief actuary in the insurance division of GAD, was a member of the working party which reported on 30 September 1995.

147. The Brindley working party had reported earlier. I have commented on the profession's views of PRE and its treatment in the context of valuation. There was a tendency to understate the importance of the centrality of the policyholder: the policyholder's reasonable expectations were equated with those of the expert. The implication was that the expectations generated by documents sent and information provided to the full range of policyholders should be measured by the reactions of a sophisticated sub-class of policyholders as assessed by the actuary. The actuary, and in particular the appointed actuary, had a role in assessing what policyholders' expectations were and reporting on them. But that role was to form an objective view of what would have been communicated to the generality of policyholders, not to substitute the actuary's view, especially where, as in the case of the Equitable over much of the period with which I have been concerned, the appointed actuary was chief executive and had control of the publications. Further, the appointed actuary's role did not extend to substituting the appointed actuary's assessment of the reasonable expectations of policyholders for the independent view of the regulator.

148. An aspect of the emphasis given to an actuary's view of PRE in the professional papers referred to was the conceptualisation of the question. PRE was not a 'concept', as the report of the Brindley working party sought to characterise it. It was simply a criterion for the exercise of regulatory power that depended on an analysis of the facts and circumstances at the time the exercise was contemplated. The attempt to conceptualise the expression appears to be part of the difficulty with the profession's approach.

149. The sum of the advice and discussion referred to was that policyholders' expectations were formed through the actions of and communication by the office. But there appears to have been some reticence within the profession over explaining how offices went about running the with-profits business, forming and developing bonus philosophy and about how policyholders' interests were ascertained. Complexity was often given as justification for asking policyholders, and in some cases directors, to leave matters to trust. Policyholders' expectations were almost bound to be distorted if they were given incomplete (or inaccurate) information, for example on the expected trend of future returns, or on the reasons for high/low past returns, especially during times of change. There was no agreement within the actuarial profession as the how compliance with PRE should be implemented.

150. These developments were part of the context in which regulatory policy and practice developed. Within DTI and GAD discussions continued. By June 1996 the possibility of legal challenge of the official view was being considered. Counsel advised the preparation of a background note in anticipation. The historical note of 18 April 1986[14] and Hewitson's paper of 21 July 1993 were resurrected and circulated. Allen asked Rathbone to review the treatment of asset shares as a measure of PRE. On 8 August 1996 Rathbone produced new material to add to Hewitson's paper as follows:

> "6.4. Asset shares are, as stated in 4.2. above, regarded as a satisfactory method of determining the balance of interests between different groups of policyholders in an equitable way. However the suitability of asset shares as a means of quantifying policyholders' reasonable expectations will crucially depend upon the assumptions used in their calculation.
>
> 6.5. There are no generally accepted actuarial principles in respect of the calculation of asset shares. They are calculated by offices on a wide range of bases - from a full accumulation of the profits derived from all sources whilst maintaining the minimum necessary estate (as for Equitable Life); to a basic policy value, represented solely by the accumulation of premiums less costs at

[13] See paragraph 85 above.
[14] See paragraph 103 above.

the investment return earned on the fund, leading to an expanding, unutilised estate (as for Prudential). It can be seen that the use of asset shares does not automatically ensure fairness for policyholders, but often acts merely as a guide to balance the interests of different cohorts of policyholders. In particular, the actuarial profession does not have a consensus view on the extent to which asset shares should be enhances to recognise releases from or contributions to the estate.

6.6. The estate can be regarded as the working capital of the with-profit fund and is represented by assets of the fund over an above those which are notionally earmarked to provide current policyholders' benefits (the latter is in many offices determined as the aggregate of the asset shares for all policies). A with-profit fund would normally maintain a sufficient estate to enable it to operate as a going concern without reliance upon contributions from external sources, such as share capital. Working capital is required to finance the profitable expansion of the business, to enable a suitable bonus smoothing policy to be adopted and to provide a buffer to enable the company to adopt a more volatile investment policy, geared towards equities, in the longer term interest of its policyholders.

6.7. Historically estates have, with minor exceptions, been wholly generated from the retention of surplus earned from policyholders' funds. Such estates are passed across generation of policyholders with each generation contributing to it according to the then requirements of the business. Policyholders would reasonably expect the appointed actuary, when making his recommendation to the board regarding the amount of surplus which can be distributed, to seek to optimise the amount of the estate so that over the medium term it is neither excessive nor inadequate. To the extent that the directors decide that the current generation of with-profit policyholders needs to make a contribution to the estate then it would be reasonable for an appropriate deduction to be made from their asset shares. However the with-profit policyholders would also reasonably expect their asset shares to be enhanced by their share of any part of the estate which is determined to be excessive."

151. Allen amalgamated the material and returned the product to Rathbone on 13 August 1996. On 16 August 1996 Rathbone made a further amendment to identify differences of opinion within the profession:

"6.8. The actuarial profession set up a working party to consider "the ownership of the inherited estate". The inherited estate was defined as those long term assets which would not normally be required to satisfy the reasonable expectations of policyholders. Differences of opinion emerged in the working party on the rationale for determining the balance of interests of policyholders and shareholders in the inherited estate. Similar differences of view were expressed when the profession discussed the working party's report at a sessional meeting and no consensus was reached on the issue. The essential difference is that some actuaries favoured the concept of classes of policyholders being entitled to share in the distribution of profits irrespective of when they were earned, a view favoured by the DTI, and others held the view that the principles of equity and reasonable expectations would be fully served by giving each generation of with-profits policyholders its full smoothed share of the profits earned by that generation plus the backing of sufficient inherited estate to ensure that policyholders' expectations associated with either normal or adverse conditions can be fully met."

152. In October 1997, following the announcement in May that there was to be single financial services regulator, the prospect of new legislation was raised. In a memorandum to Allen dated 20 October 1997 Hewitson wrote:

"Legislation which deals with PRE, distribution of surplus to policyholders (and shareholders), the ownership of the Estate and the management of the

long-term fund must be based on the four key principles described below. The principles are described in terms of their application to with-profit funds but, as demonstrated below, can also be applied to unit-linked business. The principles also assume that the new legislation will continue to require the separation of assets and liabilities attributable to long term business and to require control over the application of the long term assets. This is a core requirement for long term insurers which will need to be provided for in primary legislation so that the unique winding up arrangements for long term insurers can be preserved.

1. The Key Principles

1.1. Fairness. This would require the equitable treatment of policyholders within a cohort and between cohorts

1.1.1. A cohort is a group of policyholders who have similar interests in the long term fund. A cohort could be all with-profit policyholders or with-profit policyholders entering the fund in a particular year or an identifiable class of with-profit policyholders; or all investors in internal linked funds or new entrants of leavers of a particular linked fund.

1.1.2. Currently this principle of fairness is covered in actuarial professional guidance (GN1) and also to a limited extend under s31A of the ICA82 [Insurance Companies act 1982] and probably under the PRE references in the ICA.

1.1.3. The use of asset share techniques might be one was of demonstrating compliance with the fairness principle for with-profit policyholders

1.1.4. For unit linked policyholders it may be necessary to require internal linked funds to be run on unit trust principles, without requiring trustees and the total segregation of trust assets.

1.2. Transparency. This would require clarity of the relationship between disparate parties to an agreement i.e. policyholders, shareholders and members.

1.2.1. This could, for example, require disclosure of the principles of management of the estate ... and lay down (or require clear disclosure of) the basis for the apportionment between the parties of the distributable surplus of a participating fund and. If appropriate, set restrictive conditions that would need to be satisfied before that apportionment basis could be changed.

1.2.2. It is unsatisfactory that the directors can determine the level of surplus to distribute from a with-profit fund (without legislative control over their actions) and that the shareholders can unilaterally change the basis of apportionment of that surplus by amending their Articles.

1.2.3. Currently s30 of the ICA82 seeks to restrict the latter but it gives too much scope to amend the apportionment basis and also does not adequately cover the position of with-profit sub-funds.

1.2.4. The disclosure aspects are to an extent covered by the PIA with-profit guide, although the guide is only required to be supplied to policyholders on request and is not required to be produced in respect of all with-profits business.

1.2.5. The transparency principle could also cover the requirement to clearly disclose the charges to be applied to unit-linked business both at a policy and at a fund level and the circumstances in which those charges can be varied (currently this aspect falls under PIA disclosure rules).

1.3. Certainty. This would require clarity in the way that the company manages the long term business.

1.3.1 There should be no uncertainties in the system which might obscure the interests of policyholders.

1.3.2. The biggest uncertainty in a with-profit fund, once the basis of apportionment of distributable surplus is clarified, is the power of the directors to exercise their discretion to determine the amount of distributable surplus.

1.3.3. It would be very difficult to draft legislation which dictated the amount of surplus which should be distributed.

1.3.4. The solution could be (as referred to above under the transparency principle) to require the company to disclose the amount of the estate, how it manages the estate and how it determines the amount of the distributable surplus (a commercially sensitive issue?) and require the directors and the appointed actuary to certify that the retained surplus is not excessive.

1.3.5. There would also have to be powers to require companies to provide supporting information on a confidential basis to the regulator (the Financial Condition Report?) and a highly interventionist power requiring a company to modify its distribution policy if the estate was considered to be excessive. In practice, this latter power may prove difficult to enforce ....

1.3.6. In order to provide some ongoing certainty about the relative distribution between policyholders and shareholders, the only real solution may be to legislate that no more than, say, 10% of the distributable surplus arising in a with-profit fund can be distributed to shareholders and that a 90/10 fund cannot be subsequently re-divided (e.g. into 90/10 and 0/100 sub-funds).

1.3.7. Distributable surplus would need to be defined so as to include any removal of assets from a with-profit fund other than for the reimbursement of expenses properly incurred for the purposes of the long term business.

1.4. Practicality. This principle is fairly obvious and would require that any legislation was capable of being applied or enforced.

1.4.1. An example of impractical legislation ... is the power to require a company to modify its distribution policy.

1.4.2. The regulator would presumably invoke this power on the grounds that it considered that the estate was excessive resulting in surplus being unreasonably withheld and policyholders' reasonable expectations not being fulfilled. The regulator would form this view on the basis that its actuarial advisers knew better than the directors and the appointed actuary how much surplus could reasonably be distributed. However, the regulator would be relying upon information, of a largely subjective and uncertain nature, which had been supplied by the company regarding its expected future development plans, its likely future investment and bonus policy and the amount of its free estate.

1.4.3. Other than in extreme cases, it is doubtful whether the regulator could adequately defend its actions under judicial review depending of course on the way that the law is framed. The argument would almost certainly be based upon whether or not PRE are met i.e. whether participating policyholders reasonably expect to share in 90% of any surplus which may be distributed from a with-profit fund (the current DTI policy) or whether they only expect to receive a reasonable return on the premiums that they have paid (the asset share approach)

1.4.4. The legislation creating the power will achieve no practical effect unless either the distribution basis or PRE is also defined.

2. Applying the principles in the Regulatory Reform Bill [the term then used to refer to the proposed legislation that in due course became the Financial Services & Markets Act 2000]

2.1. In summary, we believe that the Bill should:

2.1.1. Retain the concept of the separation of the long term business as set out in s28 and s29 of the ICA and the winding up provisions in s53 to s59

2.1.1. Introduce the concept of sub-funds within the long term funds and require that transactions within and between sub-funds are equitable to all parties (i.e. a s31A type clause). A sub-fund could be a with-profit fund which forms part of the long term fund or an internal linked fund within a sub-fund. A with-profit fund should be defined as that part of a long-term fund where there is an established surplus in which long term policy holders of any category are eligible to participate.

2.1.3. Require that the directors should manage each sub-fund with due regard to the interests of policyholders who have an interest in that sub-fund and introduce a power which would enable the regulator to require the directors to do so, similar to s45 of the ICA. In particular, the power should enable the regulator to require that the directors should modify the distribution policy of a with-profit fund.

2.1.4. Set a limit on the amount which can be withdrawn in any year from a with-profit fund and paid to a connected party, say 10% of the distributable surplus. Distributable surplus is a year would be defined as the value of amounts attributed to policyholders of the with-profit fund plus any amounts paid to connected parties in respect of that year. The value of the amounts attributed to policyholders should be determined using realistic assumptions rather than the prudent assumptions used in valuing the liabilities. The amounts paid to connected parties should include any removal of assets from a with-profit fund other than for the reimbursement of expenses properly incurred for the purposes of the long term business and the shareholders fund.

2.1.5. Place a restriction that any subsequent division of a sub-fund can only be made in accordance with the principles in 2.1.3. and 2.1.4.

2.1.6. Remove the current s30 of the ICA. The overall limit proposed in 2.1.4. above, the powers suggested in 2.1.3. and the disclosure requirements of 2.2 below should make a 0.5% restriction unnecessary.

2.2. In addition the following disclosure issues should be covered in secondary legislation:

2.2.1. Full disclosure should be made of all material aspects of the management of a with-profit fund (such as the amount of the surplus in the fund, how the distributable part is determined and details of transactions between sub-funds) and the directors and the appointed actuary should certify, if that be the case, that the retained surplus is not excessive.

2.2.2. An annual financial condition report should be submitted to the regulator on a confidential basis which demonstrates, inter alia, that it was reasonable for the directors and the actuary to sign the certificate referred to in 2.2.1.

2.2.3. Full disclosure should be made of all charges which can be applied to a sub-fund, with particular relevance to charges made by connected parties, and the circumstances in which those charges might be increased.

> In this respect a charge should be defined in the broadest sense to cover any removal of assets from a sub-fund including, for example, distributions to shareholders.
>
> 2.2.4. Disclosure should be made to policy holders whenever a discretion to increase a charge (including the percentage distribution to shareholders) is exercised. The increase should be disclosed to policy holders within a reasonable time of the change occurring."

153. This document was delivered at a time when the Consumers' Association were taking an active interest in orphan assets and pensions compensation, and communicating with Treasury Ministers about the need for legislation. In connection with mis-selling liabilities the Association was referred to the answer to the Parliamentary Question dated 16 June 1997. In relation to orphan estates reference was made to a statement made by the Minister for State for Corporate Affairs in February 1995. Preparations for a meeting with representatives of the Association became a priority.

154. In May 1998, the Treasury Select Committee sought information on the topic. On 29 June 1998 the Economic Secretary was advised on the terms of a proposed answer to a question on the use of power to intervene on PRE grounds. The answer included:

> "Am not aware of any occasion on which formal use has been made of section 45 for the purpose of protecting policyholders' reasonable expectations. But the mere existence of the power has to date been sufficient to make its exercise unnecessary. In practice, the Secretary of State and the Treasury as successive regulators have been able to protect policyholders' interests by influencing companies' behaviour through discussion and agreement.
>
> Guidance on the Government's view of policyholders' reasonable expectations was set out in a statement by the then Minister for Corporate Affairs on 24 February 1995 ..."[15]

155. On 7 July, Allen sent a draft submission to Hewitson on the attribution of inherited estates. Following consultation, this resulted in a submission to the Economic Secretary on 16 July 1998. In his covering letter to Hewitson, Allen referred to the Consumer' Association concern:

> "When we met CA officials on 16 June to explore their concerns in more detail, it was clear that they regarded the existence of large estates as an encouragement to sloppy management; but after we had explained that a with-profits fund needs an element of estate to operate, and explained against that background the rationale for our policy on both inherited estates and pensions mis-selling, CA appeared to accept that there was no easy way of eliminating these large estates, and that our policy of seeking to protect policyholders by seeking greater clarity of attribution where necessary, and defending the 90:10 principle, was in practice the most effective way of protecting policyholders' interests."

156. The proposed answer to a question was:

> "The Government's position on the inherited estates of life offices was set out in a statement by the then Minister for Corporate Affairs in February 1995. The DTI, which was then the responsible authority, applied the principles set out in that statement in reaching agreement with four life offices for a restructuring of their long-term funds, and a clarification of the attribution of the interests of policyholders and shareholders in the long-term fund.
>
> A common feature of these cases is that they involved a particular type of business known as 'industrial business'. Historically, there was a lack of clarity over the development of these companies' approach to dealing with

[15] See paragraph 140 above.

> surplus arising in respect of some industrial business policies written earlier this century. Consequently, there was no clear evidence as to how surplus which had built up from these policies should be properly attributed between policyholders and shareholders. The DTI therefore reached agreement with the companies on an attribution based on reasonable assumptions, in line with the February 1995 statement.
>
> In considering any other proposals for clarification on unattributed assets, the Treasury will continue to be guided by the principles set out in the DTI statement of February 1995, and apply them to the particular circumstances of each case. In doing so, the Treasury will be particularly concerned to ensure that policyholders' interests are fully protected."

157. By now, the course of events giving rise to the inquiry was set. Perhaps unsurprisingly, in view of the lack of a developed jurisprudence and the lack of industry consensus on the factors relevant to the formation of policyholders' reasonable expectations, there is little evidence of any agreed approach to the development and modification of policyholders' reasonable expectations. The better industry view at all material times would appear to have been that PRE required to be established objectively by reference to past events and representations. Inevitably the factual matrix would change over time, and policyholders' reasonable expectations would need to adapt to the changing reality. The decline of equity market values in recent times would require to be taken into account in assessing expectations of future bonus distributions. Reasonable expectations generally must be responsive to external economic realities.

158. Of greater difficulty is the question whether and to what extent policyholders' reasonable expectations could be altered or shaped by changes of management policy. If the reasonable expectations of policyholders established by past practice and communications were that an identifiable distribution policy would be followed, and financial circumstances remained constant, it would appear that a change of direction could breach the established expectations of relevant policyholders. It is not clear that the actuarial profession had addressed issues of that kind.

CHAPTER 14: THE EQUITABLE'S APPROACH TO PRE

1. Notwithstanding the terms of GN1 version 2, the earliest comprehensive written presentation by an appointed actuary of Equitable to the Board on PRE was in a report prepared by Headdon for a meeting of 26 November 1997. His views were within the range of general industry views already discussed. He wrote:

> "6. The Insurance Companies Act and associated regulations make a number of references to 'policyholders' reasonable expectations' (PRE). In particular, it is one of the 'sound and prudent management' criteria set out in the Act that the Board manages the business with 'due regard to the interests of policyholders and potential policyholders'. For with-profits policyholders PRE would be a key element in their 'interests'. ...
>
> 7. The expression PRE is not, however, defined in legislation and each office has to form its own view of what it means in its particular circumstances. Each Appointed Actuary has a professional duty to advise his Board on what he considers the expression to mean for the office. ...
>
> 8. My broad interpretation of PRE is that it represents the way in which a reasonable policyholder would expect the office to act on the basis of information previously given. That is, the material a policyholder sees – advertisements, literature, product particulars, annual statements, Reports & Accounts etc – builds up a picture of how he or she expects the office to manage its business. PRE is then a set of actions or an approach consistent with that picture.
>
> 9. It is important to note that PRE need not (and should not) be an immutable set of rigid rules. A wise office will develop PRE in general terms which allow adaptability to changing circumstances whilst preserving some general underlying principles.
>
> 10. In the Society's case, PRE has normally been encapsulated in the phrase 'full and fair distribution'. In particular:
>
> (i) Each generation of policyholders should, subject to smoothing, receive the proceeds of their invested premiums, More specifically, there should be no deliberate retention of earnings to build up an 'estate' of assets which belong to no particular policyholders.
>
> (ii) Earnings should be distributed fairly and consistently between policies of all different terms and product types.
>
> For several years now the Society's literature has promoted these principles explicitly.
>
> 11. In terms of bonus rates the above principles create the following expectations:
>
> (i) That the total return allocated will represent some sort of average of the actual returns earned over a policy's lifetime.
>
> (ii) That policy results and bonus rates will bear a consistent and explicable relationship from policy to policy.
>
> 12. A subsidiary expectation is that a reasonable proportion of the total return allocated will be given in guaranteed form, through the addition of declared bonuses. In recent years that expectation has been made more specific by relating the guaranteed element to the general level of gilt yields."

2. Headdon's views provide a point of reference for discussion of the range and nature of the reasonable expectations that policyholders might have deduced, on an objective assessment, from the materials discussed in this chapter, and in particular from the actions and publications of the Society. Generally, any reasonably diligent

policyholder would have developed reasonable expectations about the directors' policies in relation to the pursuit of growth of business, the development of innovative products, the pursuit of a stated investment policy, the maximising of returns by investment in equities and properties, close control of expenses, full distribution and a range of other particular policies advertised from time to time.

3. The broad statement in paragraph 8 stated that PRE was a function of the policyholders' response to what was communicated by the office about the management of the business is incomplete. But, even on that basis, distribution policy would be an aspect of PRE, but not the measure of it. Further, as appreciated by the departmental officials in discussing PRE[1], the regulator may become aware of facts and circumstances that had not been communicated to policyholders in any way, but that might threaten the office's ability to meet reasonable expectations. In his analysis Headdon gave inadequate weight to the conduct, as distinct from the comments, of the Society as a factor contributing to PRE. But the statement provides a valuable insight into the understanding of the Society's staff of the requirements derived from policyholders' reasonable expectations, both generally, and in relation to participation in surpluses. It was also an explicit acknowledgement of the appointed actuary's responsibility that had no real precedent in the Society's practice.

4. It is significant that the report was made to the Board of the Society. As has been seen elsewhere actuarial reports frequently rehearsed past events and circumstances in support of recommendations. In this case the representations of particular importance are in paragraphs 10, 11 and 12. This report was presented a few months after Headdon had advised Nash of his analysis of the Society's past over-distribution and of his view that it would take some fifteen years to achieve equilibrium. That analysis of actual experience was not reflected in the advice.

5. The Society consistently, and over many years, encouraged the view that the Board pursued a policy of open communication with members. The published accounts gave particular emphasis to openness from 1986 when Professor Smith became President of the Society. In the 1986 accounts he anticipated that the Financial Services Act would have no significant effect on the Society. He quoted the comment of Professor Gower, whose report had proposed many essential features of the Act, that it was intended "to prevent people being made fools of". Smith said that the Society was opposed to any practice which could be described in these terms and when a mistake was made – whether in selling practice or administration as inevitably happened from time to time – aimed to put things right quickly. He recorded that the Society's general manager, Barry Sherlock, had been appointed chairman of LAUTRO[2], one of the new self-regulating organisations established under the new Act. The intended impression was that the Society was not only fully in tune with, but had anticipated in its practices, the new regulatory objectives and saw no threat in them to its established approach to management.

6. In the 1988 accounts, Smith expanded on the Society's position:

> "We believe it to be increasingly important in the critical world of today that existing and new clients should understand the nature of the policies they buy and the business principles which we adopt in relation to those policies. We hope that, through our sales literature, and the information provided by our representatives, there are few policyholders who are unclear about their policies. The management report, which follows this statement, contains rather more information than has been supplied in the past about our business and the principles we adopt. We support, therefore, the general thrust of regulations stemming from the Financial Services Act to require more openness from the life assurance industry."

7. In his letter to policyholders in February 1989, Sherlock said:

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[1] See chapter 13.
[2] The Life Assurance and Unit Trust Regulatory Organisation.

> "Under the various requirements flowing from the Financial Services Act, life offices will find themselves increasingly under pressure to explain their business and philosophy of operation to their policyholders. That is a development which we wholeheartedly support..."

The following year, the message was repeated:

> "At recent bonus declarations we have taken the opportunity to write to policyholders giving information about our approach to with-profits business. There is currently a great deal of emphasis, which we welcome, on making with profits policies easier to understand. The Society has been at the forefront in trying to explain with-profits business in a straightforward manner and the letters issues at recent declarations are an important element of our efforts in that direction."

The letter stated further:

> "In the competitive world in which we live we believe it is as important to be open as to do well".

8. The pursuit of business growth and the control of management and procurement expenses were aspects of policy that were widely advertised throughout the reference period. The comments in the annual presidential statement to members have been discussed in chapter 3. The corporate objective published in 1978, but pursued for ten years before that, encapsulated the policy that would have instructed reasonable expectations:

> "To provide life assurance and related facilities to as many people as is consistent with a high standard of product, service and advice."

9. In relation to the conduct of the business and policyholders' interests;

- A policyholder would have expected the Society to pursue a policy of expansion;
- Policyholders would have inferred that expansion was in the members' interests, and that policy proceeds and growth data were related even though no express representation was made to that effect.
- A member would have expected the Society to keep close control of expenses;
- It would have been expected that the Society would take advantage of technological developments to facilitate efficient management of the business;
- Policyholders would have expected investment policy to be balanced; taking advantage of the market situation that presented itself.
- A policyholder with access to the accounts for the triennium 1980 – 1982 would have understood that the fund was "invested for growth, with a consequent depressing effect on immediate income".

10. As described earlier in the report, growth continued to be a priority for the Society and to be given prominence in financial reporting throughout the period of interest. Similarly, the benefits of mutuality were described in terms that would have encouraged the reasonable expectation that the Board would endeavour to maintain the Society's mutual status. Distributed with the 1985 statutory accounts was a document entitled: "You gain because we're different". It contained representations about the Society's performance over the previous decade. It emphasised the benefits of mutuality: that there were no shareholders to take a slice of the profits; that there was no commission to middlemen so that more money was invested; and that the Society had an expense ratio of about half the average ratio of competitors. It related the benefits available from the Society to these factors.

11. A major change in policyholders' reasonable expectations would have come about by the emphasis given to the 'managed fund' approach to the definition of

members' interests. Professor Smith presented the information as established fact in his 1986 statement to members:

> "It cannot be stressed too often that members participate in a fund of investments being managed on their behalf and that this fund provides the capital base for running the business. The members are the proprietors, and their interest is expressed in the form of bonus additions."

That formulation of the directors' approach appears to have superseded finally the policy advertised in Ford Geddes' statement of 1970 justifying the holding of ample reserves to sustain the office's continuity: Equitable's justification for holding a form of inherited estate. By about this time, in 1986 or 1987, the Board's distribution policy during the period from 1982 had eroded the surplus brought forward by conservative distribution policies following the poor performance of the triennium 1974 to 1976. The 'managed fund' approach reflected current realities. But the policy set the scene for an expectation of full distribution thereafter. The approach was given increased emphasis in 1987. But there was a change in the presentation of investment policy. The market collapse of October 1987, 'Black Monday', resulted in a somewhat more sober statement, emphasising the need for diversification of risk within the portfolio, and balancing investment and bonus policies.

12. Between 1988 and 1996 the general picture painted in terms of management, the pursuit of growth, the advantages that growth brought to policyholders, investment policy and the ethos of the Society did not change materially. There was little change in 1997, when the Society was then moving towards conflict with its annuity guarantee policyholders, and it is appropriate to consider whether there were factors that might have indicated the range of policyholders' reasonable expectations of management in that context.

13. From about 1986, policyholders would have understood that they participated in a managed fund. At least from 1990 policyholders would have had a reasonable expectation that the approach to with-profits and any changes in the system would be identified in the actuary's 'dear policyholder' letters. Until 1995, no policyholder would have understood that there was a risk of imbalance of interests in bonus as between annuity guarantee policyholders and other policyholders. In and after 1996 there were indications of a risk of conflict of interests that had not previously been anticipated in the Society's published literature. But, given the Society's advertised commitment to openness of communication, there was no basis for a reasonable expectation that the Society had created a potential conflict between guarantee annuity policyholders and other with-profits policyholders.

PRE & Bonus: an Analysis of the Society's Communications

14. The contribution of the statutory accounts to developing policyholders' reasonable expectations in respect of bonus allocation developed slowly. In the 1967 accounts it was intimated that some part of the capital appreciation accrued on equities would be appropriated to supplement revenue in declaring bonuses. But no principles were stated, and there was no published method of measuring the appropriateness of the actual appropriation. There was a statement on investment policy and surplus in the 1968 accounts. The president commented:

> "When considering how the Society's funds should be invested your Directors face no easy task. It is, I think, clear that it would be right neither to rely too much on fixed income stocks giving a high yield nor, on the other hand, on equity holdings to counter inflation. Judgment must be made as to the form of compromise to be adopted. During the past year, the decision has been taken to put more than half the new money into lower-yielding investments. This carried the obligation to make up the difference to existing policyholders by bringing in increases in capital value, as we have done at the last three valuations."

15. The statement published the origins of what was to become the Board's policy of benchmarking declared bonuses to the market yield on fixed interest securities. At the time, the sole effect of the policy was to adjust the inter-generational allocation of capital appreciation by appropriating part of the accrued unrealised gains as a substitute for revenue foregone as a result of investment in equities. Members would have understood that Board policy was to acknowledge an 'obligation' to make up the shortfall in yield to existing policyholders.

16. 1970 was Ford Geddes' last year as president. His report in the 1970 accounts expressed the policy of retaining substantial unallocated reserves, in effect maintaining an estate, and the associated policy of appropriating unrealised capital appreciation for bonus distribution. The next president, Robert Henderson, emphasised investment policy. A structured approach to maintaining a suitable balance between the different types of investment held was set out in his 1971 statement. The picture was of a balanced, but relatively conservative, approach to investment policy. Of greater long term significance, the statement published the Directors' policy on surrender values that was to remain a constant thereafter. It was stated that surrender values were not and would not be guaranteed. They would be adjusted as circumstances required. A clear policy distinction was drawn between payments on surrender and at maturity that persisted throughout the Society's subsequent history.

17. In May 1971, the Society published a leaflet entitled 'Bonuses'. At that stage terminal bonus had been introduced by other offices, but the Society persisted with the bonus structures established at 1962. The leaflet discussed ideas and used language that was to have an abiding importance. It stated that premiums included a charge for the right to share in the profits of the Society. Profits derived from all aspects of its operations, including without profits policies. With-profit policyholders shared in the income and capital from a wide spread of investments, comprising equities and properties as well as fixed interest securities, and also in the profits from what is in fact the equity of the life assurance business itself. The leaflet stated that part of the Society's accumulated capital appreciation would be appropriated to augment surplus. It stated that bonuses, then all in declared and interim form, once allocated to policies, were guaranteed benefits like the sums assured. 'Guaranteed' was to remain part of the conventional language of the Society. As the document stated, by that stage, and based on a long tradition of substantial, periodical bonus additions, there arose a "natural expectation" that bonuses would continue. The Society acknowledged what one might have expected to be the reality: consistent practice generated the expectation of continuing consistency of practice.

18. The leaflet made plain that the bonus system was a creature of practice and expectation: the 'natural expectation' that substantial distributions would continue to be made. It acknowledged that there had been adverse experiences related to external economic circumstances. Although it was not spelled out, there was an implication that such circumstances could occur again. 'Natural' and 'reasonable' expectations are not necessarily the same. But this was a significant expression of the Society's understanding that sustained bonus practice did create in policyholders a recognised level of expectation about future practice. Equitable's directors were fully informed in advance of the 1973 Act of the implications of practice.

19. In June 1972 the Society published a leaflet on retirement annuity contracts setting out concise particulars of its form, with examples. In relation to bonus, the leaflet set out current policy. It described the characteristics of the annuities available, giving emphasis to flexibility as to maturity age; provision for a surviving spouse; the option to have a minimum guaranteed term; and the commutation option then available. It commented on the flexibility of the premium terms. It stated that each premium purchased its own portion of the final annuity. In relation to bonuses it set out current bonus rates and described the current practice of paying a final bonus. It stated:

> "The rate of final bonus will depend upon financial conditions at the time, with particular reference to immediate annuity rates, but for annuities currently becoming payable the final bonus is 40% of the annuity including all other bonuses or 55% if a joint life annuity is taken.
>
> The final bonus, in its present concept, reflects financial conditions at the time the annuity commences, with particular regard to immediate annuity rates at that time."

It was a clear example of a practice of describing current practice and exemplifying its application by reference to current rates. The amount was related to financial conditions current at maturity.

20. The principal difference between future reversionary bonuses and future final bonus was that the reversionary bonuses would crystallise progressively on declaration whereas the final bonus would depend on financial conditions at maturity. Retirement annuity policy illustrations provided by the Society between 1970 and 1972 stated that projections depended on the assumptions (a) that future rates of declared and interim bonuses would remain the same as the interim rates in force at the date of the illustration; and (b) that the rate of final bonus would depend on financial conditions at maturity. Natural, and reasonable expectations would have been influenced by the published information.

21. The bonus declaration for the triennium ended 1973 results marked a significant change in practice. Terminal bonus had been adopted for all with-profits business. The report in the Companies Act accounts on the bonus declaration for the triennium gave some indication of the basic bonus policy applied, but gave no indication that the previous policy had been departed from or how the new system would differ in operation. The report stated:

> "Once a bonus has been declared, it is a fixed, guaranteed liability and investment policy must reflect the need for security which that implies. In contrast, the terminal bonus which has been introduced is not guaranteed and allows us greater flexibility in determining investment policy. We believe that this freedom is to the advantage of our members.
>
> ... The report of the Actuary to the Directors explains how it is necessary to have regard to both income and capital value in determining the surplus which it is right to regard as available for allocation as bonus additions to guaranteed benefits."

The choice of the expression 'guaranteed' to distinguish declared and terminal bonus was established at the outset.

22. The grant of a terminal bonus across the Board was a new concept for the Society. Members would have inferred that such a bonus would be part of future strategy. But apart from relating the strategy to investment, there were no indications of how that would affect the allocation of total returns. Read in the light of developing industry practice the information might have generated a reasonable expectation that available funds would be held back from distribution for payment at maturity as a non-guaranteed terminal bonus, and that the immediate result would be an increase in investment freedom associated with the shift from guaranteed to non-guaranteed benefits. But policyholders would have derived little understanding of the implications for the assessment of liabilities unless they had independent information or advice.

23. In April 1974, Sherlock wrote a letter to members to accompany the bonus notice on retirement annuity contracts. He provided a projection of future results for purposes of illustration. The letter showed the effect of electing to take up the commutation option that was by then in operation. The bonus notice relating to the three years ended 31 December 1973 showed the amount of bonus previously declared and existing at 1 January 1974, and the amount of new bonus allotted as on that date. Following the introduction of terminal bonus, a further edition of the

bonuses leaflet was issued in March 1974. It repeated the analysis of previous history contained in the 1972 leaflet, and introduced the new form of credit. The introduction of terminal bonus had not altered the general thrust of the Society's analysis of how bonus arose and was allocated. But the terminal bonus was related explicitly to accrued capital appreciation.

24. The adverse investment experience of 1974 gave rise to further explanations of general policy. In his statement to members, the president said that the impact of market losses necessitated a discussion of investment policy. He explained that guaranteed benefits were matched by income and capital receipts from fixed interest investments of suitable redemption dates. The remainder of the fund was invested in a mix of fixed interest securities, equities and property with the objective of creating a growing surplus sufficient to allow the allocation of bonuses at a level which would keep pace so far as possible with inflation. He said that that required a balanced approach to investment:

> "In the event, what will determine the level of future bonuses is not so much the market value of the investments at any one time as their underlying strength and, therefore, the flow of income and capital what will come from them in the future. If the revenue from these sources grows, bonuses should continue to be attractive."

The new terminal bonus was directly related to investment. But it would not have been possible to spell out of the statement, in isolation or read together with earlier material, any basis for policyholders to form a reasonable expectation of principles or rules by reference to which bonuses would be determined and allocated. The balance between reversionary and terminal bonuses was not discussed.

25. The report illustrated, at this relatively early date, the Society's elitist self-image. Members were assured that the strengthening of regulatory controls in the Insurance Companies Act 1974 was to be welcomed as tending ultimately to give the public greater financial security. It was noted that the Society had not previously participated in any industry rescue schemes, but it might be forced into a compulsory scheme for the protection of life assurance policyholders. It was clearly thought that the members of Equitable had no need of regulatory protection:

> "It is difficult to envisage circumstances in which members of the Equitable Life could benefit from such a scheme."

The president did not see it as part of the Society's function to use members' savings to support companies that were irresponsible in their operations. The industry was to adopt a similar attitude to the Society at the end of 2000.

26. There was nothing innovative in the reports for 1975 and 1976. However, there were changes in communications with policyholders that reflected significant developments. In 1975, the form of illustration for retirement annuity business changed. The statement showed the guaranteed annuity; a projection of the annuity including bonuses, at guaranteed rates, if current declared and interim bonus rates remained at 1974 levels; and the same sum supplemented by the final bonus adjustment at the October 1974 level. In November 1975, the Society wrote to existing retirement annuity policyholders inviting them to transfer to the new series that had been introduced with higher guaranteed rights. The document contained an illustration of benefits using assumed future rates of declared and interim bonus at the same rates as the current interim rate. They also included final annuity adjustments at the October 1975 levels, and a statement that if terminal bonus at the current rate applied to the amounts of annuity set out would be increased by 10%. The cumulative effect of the several elements of the bonus system was shown. At that date, therefore, policyholders would reasonably have expected, subject always to prevailing financial conditions at maturity, that the final annuity adjustment would be applied to align the guaranteed rates with current annuity rates, and that terminal bonus would be applied at the common rate in addition. The guaranteed rates were significantly lower than the projected rates.

27. The interaction of the several elements of the bonus system was set out in a revised form of retirement annuity illustration in 1976. The factors in the illustration were described as guaranteed basic annuity; declared bonus annuity; future bonus annuity and final annuity adjustment. The notes stated that the future bonus annuity was the amount that would be added if future rates of declared and interim bonus were the same as the interim rate announced in 1974. The basic and bonus annuities were based on minimum guaranteed annuity rates. At the pension date, if current immediate annuity rates were at a higher level than the guaranteed rates, the annuity would be increased by a final annuity adjustment. It intimated that for policies effected prior to 1971, the Society was currently adding a terminal bonus when the annuity commenced, currently at 10%, which would be added if the current rate applied to the benefits payable at the pension date shown. Subject to changes in presentation and layout, the same elements were set out in illustrations in March 1978.

28. In a leaflet dated August 1976, the Society set out details of its current practice. In relation to contributions it intimated the Society's practice of sustaining benefits in case of the reduction or cessation of premium payments after three years without what would become known as a market value adjustment. In relation to the bonus system, the leaflet explained practice in relation to guaranteed bonuses:

> "Representing the 'profits' of the Society they cannot be guaranteed, of course, as they depend on future experience. However, once added the bonuses form part of the guaranteed benefits."

It explained that, in addition to normal regular bonuses the Society might be in a position to add a terminal bonus when the pension commenced. At that time all with profit retirement policies effected prior to 1971 qualified for this addition. It explained further that the illustrations were based on annuity rates guaranteed from the outset, and that if current annuity rates were higher than the guaranteed level at pension date there would be a special adjustment to the pension. The leaflet gave information about the pension options available.

29. In 1977, the Society published a leaflet 'Equitable Profits and Your Bonus 1977', in which there was further discussion of the operation of the bonus system. It noted that with-profits policyholders contributed a level of premium that created surplus funds for investment into a wide-spread portfolio and that that gave them the right to share in the profits of the Society as brought out by periodic actuarial valuation of assets and liabilities. The entire profits belonged to the policyholders and were distributed triennially: mutuality was emphasised. The leaflet explained the declaration for the three years ending 31 December 1976. Policyholders were reminded that bonuses when declared were guaranteed additions to the benefits and not cash values immediately available. The bonuses were paid, when the benefits fell due, to whoever was entitled to the proceeds of the policy. In relation to illustrations the leaflet stated:

> "No guarantee is in any way implied by these projections. The table is an example only and does not relate to your particular policy."

The dependence of future bonus on returns was emphasised generally. In relation to terminal bonus the leaflet stated that the purpose of the bonus was to allocate a final share of profits to the outgoing policyholder. This bonus might arise from a number of sources, including capital appreciation not previously allocated through the normal bonus distribution.

30. By this stage, the Society's standard form documents had created 'natural expectations' that did not differ materially as between future reversionary and future terminal bonuses in respect of their dependence on future results; and had emphasised the 'contractual' character of declared reversionary bonuses in contrast to future bonuses generally. Policyholders would have understood that the distinction was one of importance. Appropriate reserves were required for the contractual liabilities. But that did not resolve the issue whether there was a need to

take account of the 'natural expectations' generated by the Society's practice in paying terminal bonus as to continued payment of such bonuses.

31. There was a significant change in presentation following the introduction of the open market option in the Finance Act 1978. The Act made it necessary for life offices to provide a mechanism for determining the value of retirement annuity contracts for transfer purposes. Endorsements issued following on Revenue approval of amendments to pre-May 1979 policies, and new policies, defined 'policy annuity value' in relation to the annuity as:

> ".. the cash equivalent thereof calculated by reference to the Commutation Table endorsed on the Policy, as being the lump sum which would be available if the whole of that Policy Annuity were to be commuted."

The definition of the commutation option that had been available under the Finance act 1971 was adopted as part of the new mechanism.

32. The form of retirement annuity illustration was developed in 1979 to reflect the new legislation. The presentation set out the annuity benefits, and the equivalent policy annuity value, referable to the guaranteed benefits; the benefits augmented by projected guaranteed bonuses at current rates; and the benefits further augmented by terminal bonus at current rates. The policy value equivalent brought out at that stage was said to be the sum that might be passed to another life office under the open market option. An illustration sent to a policyholder went on to show that in his case the policy annuity value could provide, if left with the Society:

Table 14.1: Illustration sent to policyholder

	If annuity rates in the policy apply	If current immediate annuity rates apply
A total annuity of	£20019	£28295
Or		
A tax free cash sum of	£46582	£59788
plus a reduced annuity of	£15287	£19710

33. In the late 1990s, the interpretation of this form became controversial in the context of the Society's differential final bonus policy. But in my view there is little room for legitimate doubt about the representations made. The illustration showed the build up of the policy annuity value that might emerge on the basis set out. That value was dependent on future reversionary bonuses being maintained at current levels and on the payment of a terminal bonus at the then current rates. But the application of the sum on the hypotheses set out, if left with the Society, was not left in doubt. The same sum was applied in determining the guaranteed annuity, with and without exercise of the commutation option, and the current annuity rate alternative, again with and without exercise of the commutation option. The sums were not guaranteed. But the arithmetical process of determining the appropriate amounts was clear.

34. This was an important stage in the development of the Society's forms of communication with policyholders. Given the distinction clearly drawn between current guaranteed benefits and future benefits generally, no policyholder could reasonably have expected that the projections would necessarily be reflected in the actual future experience of the Society: variations from the assumptions would have been expected by any reasonable person. But subject to that, the representation was that a cash fund would build up and could be applied in the alternative ways set out, without differentiation. The definition of the fund in the notes was:

> "The fund is the amount of money standing to the credit of the policy which can only be used to provide retirement benefits in a form approved by the

> Inland Revenue. It is the full equivalent to the benefits on survival otherwise payable under the policy and is shown in the policy document as the 'Policy Annuity Value'."

The return on death was in similar terms:

> "Return of full fund value in event of death before retirement. In the event of death before the pension age, the Society will pay an amount equal to the full fund accrued as at the date of death and as if that date had been the selected pension date."

It appears to me to be clear that a single fund was in contemplation for all purposes.

35. The Society's leaflet 'Individual Pension Plan', published in 1979, described the retirement benefits available under retirement annuity contracts. It stated that contributions were applied to a with-profits contract in the Society's pension business fund. The Society guaranteed a minimum level of pension from a particular contribution, but the pension ultimately arising depended on future bonuses. It was said:

> "The benefits will depend also on annuity rates. Guaranteed rates are incorporated in The Equitable's policy. If at the relevant time the appropriate current immediate annuity rates are more favourable, they will be used. (There is also the option to use the fund to secure benefits from another life office.)"

Again it is clear that the representation was that the 'fund' could be transferred or used to calculate either the guaranteed annuity or an annuity at current annuity rates.

36. The president's statement on the 1979 results commented on the 1979 declaration and on the bonuses structure. He explained that adjustments had been made to the relationship between the various rates to ensure a fair distribution between members:

> "In deciding how to distribute the surplus, the directors recognise the need to be fair to all holders of participating policies, some effected recently and others many years ago; some participating in surplus for a short period and others for a long time, even for the whole of life; some are in the taxed, others in the tax-free part of the fund and there are other special factors affecting particular classes. Equally important is the need for consistency in the determination of surplus from time to time to ensure that no group of policyholders receives too much or too little surplus while the policies are in force."

37. Smoothing was described in broad conceptual terms, as was the objective of fairness among classes of policyholders. Inter-generational fairness was implicit in the statement of the importance of ensuring that surplus appropriate to the period the policy was in force was available.

38. This was an assertion of the fundamental policy of the Board in relation to bonus allocation: bonuses were at the discretion of the directors, and it was for them to determine the nature and extent of differences among varying classes of participating policyholders. The implication was that there was no requirement to spell out policy beyond that. However, in asserting the Board's right to distinguish one class of policyholder from another in deciding on distribution, the statement created a clear basis for the expectation that if there were relevant grounds for such a distinction they would be reflected in the distribution.

39. Pausing at this stage, I consider that, in summary, the reasonable expectations of policyholders at this period would have had regard to a number of factors:

i. The directors had and asserted a wide discretion in the allocation of bonus.

ii. Some capital appreciation would be taken to revenue and used to fund current bonuses.

iii. Smoothing would be applied and would be understood to apply within the broad terms described.

iv. The objectives of fairness among classes of policyholders and inter-generational fairness had been expressed.

v. There would be appropriate variation of benefit rates as among classes of policyholders and durations.

The revised 1979 policy illustration would have influenced policyholders' reasonable expectations. Factors would have included:

i. That the policyholder and potential policyholder would have understood that there was a promise to pay on the basis of a computed fund at the rate basis selected, and independently of that selection.

ii. It would have been understood that variability of future declared bonuses and of the terminal bonus would be related to prevailing financial conditions.

iii. It would not have been expected that the exercise of a contractual right would be a factor in the determination of final bonus. That was not identified as a ground for distinguishing between classes of policyholders.

40. In 1980 there was a change from triennial to annual compounding of bonuses that was described in the accounts. The publication 'Bonuses' dated March 1980 illustrated the Society's bonus policies and practices and described the bonus system in operation. The guide distinguished terminal bonus payments from guaranteed benefits accruing under the policy. It was made clear that terminal bonus was not guaranteed. It described the process of valuation of the Society's liabilities, and the determination of the distributable surplus. The guide provided a table of terminal bonus rates for level annual premium business, such as endowment and whole life business. Terminal bonus rates were expressed as increasing percentages of the sum of the guaranteed benefits declared and interim bonuses accrued to maturity. Terminal bonus in respect of retirement policies was to be calculated by applying the lower of the rates tabulated for endowment and whole life policies and increasing percentages of the sum of declared and interim bonuses. Materials available to prospective policyholders included leaflets describing products and bonus philosophies, and illustrations of benefits secured by given levels of contributions.

41. In illustrative tables showing "How bonuses grow", the publication set out the Society's position: the pension "actually payable" was stated; the "basic policy annuity value" was stated, and a final column showed "Total Policy Annuity Value and bonuses", expressly available under the open market option as an alternative to taking the pension from the Society. Practice at this stage reflected implementation of Ranson's recommendation that the 'so-called final bonus announcement' be abandoned and that a single terminal bonus be added at maturity. Any informed reader would have appreciated that the Board's view was that declared bonuses were, but that future reversionary bonuses and terminal bonus were not, guaranteed. The possibility that terminal bonus rates would be amended was advertised. The factors that might be taken into account in resolving on a variation were not fully discussed.

42. The 'Bonuses' guide did not distinguish between retirement policies and other with-profits business in respect of entitlement to terminal bonus. The mechanism would have been clear to a typical reader: terminal bonus was a simple function of the total guaranteed and currently accruing benefits and a rate derived from one or other of the terminal bonus tables. No other condition or qualification was mentioned. The purpose of the terminal bonus was to allocate a final share of profits

to the outgoing policyholder. There was no express reservation of a right to re-compute at maturity on grounds not related to investment returns. There was no suggestion of the policyholder being entitled to anything less than the projected value according to whether he sought to receive benefits on the basis of the annuity guarantee. The prospective policyholder would have been provided with a statement in a form prescribed by head office setting out the benefits which would accrue at maturity on assumptions that current bonus policy and practice would continue. The policy annuity value brought out, including the non-guaranteed final bonus, was applied in relation to the guaranteed annuity, the open market option and the current annuity rate option. Illustrations included in the schedule to individual personal pension policies at this time made the position more explicit. The form stated that the illustrations were based on minimum guaranteed annuity rates, and explained that if, at the time the pension was taken, the appropriate current immediate annuity rates were at a higher level than the guaranteed rates, the pension and bonus pension secured under the policy would be 'correspondingly' improved. A corresponding improvement in benefits could only have been achieved by applying the higher current annuity rate to the cash fund already used in the basic calculation. The practice at the time remained that bonuses were intimated in the form of bonus annuities.

43. The retirement annuity bonus notice for the triennium 1980 to 1982 reflected a change of practice. In response to the open market option, the emphasis moved towards presenting information in fund form. The tables brought out the value of the current guaranteed fund and expressed the annuity at guaranteed annuity rates. The bonus rate of 9¼%, the reversionary bonus additional to the investment roll-up rate, was added. The statement then provided an illustration of the effect of projecting current interim bonus rates, the effect of a terminal bonus at current rates, and finally the annuity at current annuity rates projected forward to the illustrated pension age of 70. Future bonus rates were said to be dependent on financial conditions. The application of the current annuity rate alternative was illustrated by reference to the accumulated fund. The mechanism involved only the substitution of the current annuity rate for the rate guaranteed in the policy. An express option to take an annuity at current annuity rates had been introduced in the May 1979 form of retirement annuity contract. In this statement there was a promise, subject to investment conditions, that the current annuity rate would apply if in excess of the rates guaranteed in the policy. The presentation of the information would have encouraged the view that the policyholder's interest could now be expressed as an accumulating cash fund, that the fund would be converted into an annuity at rates guaranteed in the policy at maturity with the benefit of any growth over the remainder of the duration of the policy, and that the annuity would be increased if investment conditions permitted. This could operate only as an alternative expression of the contractual rights. Significantly, however, the illustrations based on a common fund value were used to express the alternative benefits available.

44. A number of factors would have contributed to the build up of policyholders' reasonable expectations relating to distribution policy at this time. In respect of terminal bonus, these would have included:

i. The expectation that there would be terminal bonus as a non-guaranteed element of the total bonus strategy that allocated a final share of profits to the outgoing policyholder.

ii. The understanding that investment conditions might change and affect the availability or rate of terminal bonus since the terminal bonus would be related to prevailing financial conditions.

iii. An understanding that if terminal bonus was available at maturity, the guaranteed annuity and the alternative current immediate annuity calculations would have been carried out relative to the same policy annuity value including terminal bonus.

iv. It would have been understood that there was a promise to pay the annuity on the basis of a pre-determined fund at the rate basis selected independently of that selection.

v. No policyholder or prospective policyholder would have expected that the exercise of a contractual right would be a factor in the determination of final bonus.

45. The Society's publication 'With-Profits Retirement Policy for the Self-Employed' issued at the time set out the background to developing practice. The general description of the business identified the essential feature of the Society's with-profits contracts as being that they effectively provided the opportunity for investment in a managed fund of assets. 'Managed fund' superseded 'policy annuity value' in the process. The leaflet explained:

> "With every contract a fairly low minimum return is guaranteed, the guarantee depending upon the precise type and form of contract. Earnings on the assets ... in excess of those required to meet the guarantees are passed on to the policyholders by way of 'bonuses'.
>
> Bonuses are declared and allotted following the annual valuation of the Society's assets and liabilities by its Appointed Actuary. These bonuses, once allotted, themselves become guaranteed additions to the contracts. A final share of profits is also allotted at the point the policy benefits become contractually payable.
>
> The ... with-profits system ... smoothes out fluctuations in earnings and asset values generally associated with investment in such portfolios. The benefits of the investments accrue steadily throughout the lifetime of the policy."

In describing benefits, the leaflet stated:

> "The principal benefit is pension provision by application of the full value of the fund built up under the policy. ...
>
> Different types of pension may be chosen at the time you decide to take the benefits. ...
>
> An important option at pension age is the opportunity to take part of the benefits as a tax-free lump sum. The balance of the benefits comes to you in pension form, as previously described. ...
>
> If you die before the pension has commenced, the Society will pay the full value of the fund built up under the policy to the date of death."

There was a single "full value of the fund". The policy illustrations continued to reflect that position.

46. The field force were informed of current practice in a memorandum from the marketing manager dated 30 April 1982 on new retirement annuity illustration forms:

> "The new forms incorporate the following improvements ...
>
> The "Annuity per annum" column of figures has been omitted, in order to give greater prominence to the value of the fund.
>
> Note that the expression "Policy Annuity Value" has given way - on the front of the form - to the term "Fund", since that term is more readily understood by the prospective client and is used by a number of other companies.
>
> It is intended to amend other items of retirement annuity literature to give a similar emphasis to the value of the fund built up under the policy, and consideration will be given to each item as it comes up for reprint. ..."

The Society set out deliberately to develop policyholders' understanding of the fund concept at this time.

47. There were no significant changes in practice in 1983. Towards the end of 1984, the form of policy illustration issued to existing policyholders reflected a number of changes of language from the illustrations already mentioned. The benefits were built up in fund form. They set out the basic benefits: existing declared bonus, and additional bonus if current bonus rates continued up to the pension date but excluding any terminal bonus, to bring out a total projected fund excluding any terminal bonus. The form then set out the total projected fund if, in addition, terminal bonus at the current rate applied at the pension date. It then stated that the specified projected fund, if left with the Society, could provide the alternative benefits specified, depending on whether guaranteed rates or current rate applied, and depending on whether or not the commutation option was exercised. The basic benefits included the investment roll-up rate guarantees, with the bonuses separately identified. The differences in language reflected in the change from "the policy annuity value" to "a projected fund", in my view, would have strengthened the policyholder's view that the Society now viewed his interest as a fund that could be applied in a range of ways at maturity.

48. The Society issued a revised leaflet 'Retirement Annuities Details of the Society's Contract' in 1984, adapted for use in connection with recurrent single premium business. The document advertised the advantages of that form of contract. The policyholder had total flexibility of premium payments, as in a classic single premium contract, but with the basis for all future premium payments and annuity rates at retirement guaranteed at the outset. There was an unqualified premium guarantee. The advantage for the policyholder, along with the other aspects of flexibility also set out in the leaflet, were to become a problem for the Society when the annuity guarantee issue emerged in the 1990s, but were a marketing advantage at the time. In summarising the benefits of the contract, the leaflet stated:

> "Ultimately, the major factors which will influence the amount of pension available under this type of arrangement will be the investment performance of the Fund Managers and the expenses control of the life assurance company."

There was no suggestion that the amount of pension would be affected by the selection of form of benefit.

49. The Society's published position was described in a letter to a policyholder in January 1985. The build up of fund value was illustrated. It was noted that the projected fund could be taken either as an annuity or as a tax-free cash sum and a reduced annuity. The relative figures were expressed at current immediate annuity rates. The writer explained that, should interest rates be low at the time the policyholder took the benefits, then certain annuity rates were guaranteed in the policy to apply to ensure that he enjoyed an attractive level of benefit. The clear implication from the last sentence was that the guaranteed rates would apply to the same fund.

50. Over the period 1984 to 1985, there were warnings that future surpluses might fall. The warning in 1984 was directed specifically to new policyholders, and reflected an appreciation of the importance of the accounts in the formation of the reasonable expectations of prospective policyholders who had access to them. In 1985, the president explained a further shift in balance towards significantly higher terminal rates for 1986. At this stage, informed members would have understood that the Board had begun to pursue a policy of reducing the proportion of total benefits ultimately expected to be paid for which technical provisions required to be established in the published accounts. That did allow increased equity investment. But it also permitted the presentation of a stronger balance sheet than would have been possible under earlier bonus practices. Crudely, for any given level of solvency margin, the lower the proportion of guaranteed benefits, the higher the proportion of prospective benefits that the policy put at risk. In this report the drift towards terminal bonus was clear.

51. As mentioned in the last paragraph, the implications of the shift included a proportionate reduction in the share of ultimate policy proceeds for which the Society had to set up technical provisions. With hindsight that was a material factor affecting the Society in later periods. A policyholder reading the report would have been entitled to conclude that the policy was driven primarily by investment considerations and did not have a material bearing on total policy values. The overall impression would have been that the distinction between reversionary and terminal bonuses was, so far as the financial interests of the policyholder were concerned, simply a matter of timing of the recognition of value.

52. Other publications and communications in 1985 continued to emphasise the concept of the managed fund. The presentation was of a fund being built up in respect of the policy, increased both by contributions and by bonus additions representing a share in the profits of the Society. At retirement, the fund was 'transposed' into an annuity. The policy allowed selection between different types of annuity at retirement and permitted a part of the benefits to be taken as a cash sum. The forms now in use did not contain quantified forward projections as previous forms had done.

53. Individual bonus notices followed the same pattern. There was no illustration of projected values. The document stated that future bonuses, representing the profits of the Society, could not be guaranteed. It was stated that the Directors reserved the right to vary the rates of interim bonus at any time. There was no quantification of terminal bonus on any hypothesis. On this presentation there would have been a reasonable expectation that there would be interim and terminal bonuses as part of the Society's overall bonus package, though the rates would be variable depending on results. The lack of projections would have left the policyholder less well informed about possible levels of value than he would have been at the end of the previous triennium.

54. Sherlock's 'dear policyholder' letter for the year to 31 December 1986 accompanying the bonus notice intimated changes to the bonus system one of which had long-term consequences. There was a change in the treatment of terminal bonuses. The letters differed in detail depending on the policy class involved. But the essential information was that interim bonus, terminal bonus and the allowance for each complete month of the part year between the last anniversary and the date on which the benefits are taken were to be amalgamated into one item to be known as final bonus. Benefits payable after 1 April 1987 were therefore comprised of three elements – the guaranteed policy benefits secured by the premiums paid, the declared bonuses attaching to the policy, and a final bonus. There were differences in detail in other forms that are not material for present purposes.

55. The bonus notice described the fund concept: a fund built up by the contributions made and by bonus additions representing a share in the profits of the Society. It stated:

> "At retirement, the fund is used to secure benefits which include various types of annuity and a cash sum... Legislation now permits the fund under the policy to be considered an open market option so allowing the purchase at retirement of an annuity from any life insurance company. The details below show how the bonus just declared has improved your policy fund and also express the total benefits guaranteed at pension age as an annuity in the form guaranteed in the policy document."

This form represented the 'fund' expression of benefits as primary. There were comments on some of the options that might be available. The financial information was similar in detail to the previous year's presentation.

56. In the 1986 statutory accounts, Smith commented on the members' interest in a 'managed fund', and the current bonus system, distinguishing declared and final bonus. He explained:

> "The final bonus added when the claim is paid ensures that the member gets a fair return overall covering the period of membership of the fund but, of course, the member has uncertainty about the amount which will be paid until the last moment."

He said that implementation of bonus strategy required that as much as was prudent should take the form of declared bonuses. That required holding assets that were guaranteed, such as government stocks, which bore a proper relationship to the value of the guaranteed liabilities to be met in the future. Secondly, reserves should not be built beyond what was needed for the benefit of newcomers who had neither contributed to them nor taken the 'proprietors' risk. The Board, advised by the Joint Actuary, would continue to ensure that bonuses allocated from time to time were fair, bearing in mind stock market volatility. The managed fund concept was strengthened and full distribution was advertised as a guiding principle. The implication was that the whole with-profits business was conceived in terms of a single fund. The bonus system expressed the members' interest in the business. The contractual effect of declaration was expressed strongly. Smith said that he believed that the Society was probably entering a period of lower investment returns and that bonuses, in particular declared bonuses, would have to reflect that.

57. The president's statement was supplemented by a 'Statement of Bonuses', which illustrated the bonus rates and their application to selected examples. 1986 was the first annual declaration. The change to annual declarations had implications for management, and technical changes were introduced to facilitate computation. The single 'final' bonus roll up of all final elements of value, as described in Sherlock's letter, was implemented. Final bonus rates were said to vary by policy type reflecting inter alia the variations in the terms on which policies had been sold within specified classes. 1986 was part of a period of transition. At least by the date of publication of the Accounts it was known that personal pensions would be introduced in substitution for retirement annuity contracts: the Society was developing its plans to provide the new form of policy. But the variations in policy terms reflected in the range of final bonus rates were those that reflected the older forms of business.

58. Communications with individual policyholders in 1986 and 1987 made few changes in practice. Pension benefits illustrations showed separately the benefits relating to premiums already paid and benefits relating to additional premiums that might be paid at the next payment date. The prospective premiums had no existing declared bonus value. The information provided in respect of past premiums showed values for basic benefits; existing declared bonus; additional bonus projected to the forecast pension date but excluding any terminal bonus, bringing out the total projected fund excluding any terminal bonus. The sum was then augmented for terminal bonus assuming that the current rate applied at the pension date. That projected fund was then expressed in annuity form, in the alternative at the annuity rates guaranteed in the policy and at current immediate annuity rates, with and without commutation. Despite the changes in the general system, the form was in substantially the same terms as before. The notes stated, inter alia, that future bonuses depended on future profits and could not be guaranteed. Note 9 indicated that current annuity rates were affected significantly by current financial circumstances. The indication to policyholders was that future bonus allocations would depend on prevailing financial conditions.

59. I have already referred to the controversy that arose later over these forms. In a letter to a policyholder dated 14 October 1998, it was asserted that this particular form of policy illustration showed how benefits might arise *if* guaranteed annuity rates applied to the full cash fund, not *when*, implying that the form left open the possibility that the guaranteed rates would not be applied to the full fund, but allow the differential terminal bonus policy to be applied. In my view this interpretation of the documents was and is completely insupportable. The structure and meaning of the form would have been clear to any reasonably intelligent policyholder.

60. Moreover, the 'managed fund' approach, as explained internally at the time, implied a continuing interest in the growing fund. In instructions to the sales force, issued in 1987, Ranson outlined the explanations to be given to policyholders enquiring about the reduction in the 1986 bonus declaration, and referred to the 'managed fund' approach;

> "The bonus systems are designed to ensure that policyholder's benefits reflect the performance of the 'managed fund' during the time that they are in the fund. The bonus systems are arranged so as to give a degree of stability in results by some smoothing and averaging of performance since it is felt that that is an essential feature of the with-profits approach.
>
> Bonuses which are allotted following the annual valuation become guaranteed additions to the benefits and can be considered as 'consolidating' some of the appropriate investment return to date. The balance of the investment return is retained in 'unconsolidated' form within the fund and forms the basis for the 'final bonus' which is paid when the policy eventually comes to an end. Clearly, what is of prime importance to the policyholder is the overall return earned on the fund during the lifetime of his contract and the reflection of that in the benefits ultimately payable – the precise split between 'consolidated' and 'unconsolidated' is less important although, given the essential nature of with-profits business, the proportion of earnings consolidated needs to be reasonable."

He commented that the consolidation of capital appreciation in equities tended to have a constraining effect on investment policy. The sales staff were instructed to inform investors that the split between guaranteed and non-guaranteed benefits was less important than the aggregate of the elements. That was the case if and only if the conditions qualifying the policyholder's rights to the two elements of value were broadly the same. It would have been inconsistent with this advice for there to be a condition of qualification for a given level of final bonus related to the policyholder's election among the range of available benefits. Yet this was a critical stage when the introduction of the personal pension to supersede the retirement annuity contract was already anticipated, and the new form would not have an annuity guarantee. The contingent risk of conflict of interest between policyholder groups would be inherent in the approach adopted. Earlier, I have explained by conclusion that by early in 1983 management had in mind to apply in some form a differential terminal bonus policy. This was a stage at which it would have been appropriate to inform RAP policyholders of the potential consequences for their benefits if that policy were implemented.

61. In 1987, the Society published the last edition of the leaflet 'With-Profits Retirement Policy for the Self-Employed' that has been recovered. The managed fund concept was repeated. The guaranteed annuity return and the bonus system were described in familiar terms. The document stated:

> "The attraction of the with-profits system is that it provides an opportunity for investment in an actively managed and wide-ranging portfolio of assets. It also smoothes out fluctuations in earnings and asset values generally associated with investment in such portfolios. The benefits of the investments accrue steadily throughout the lifetime of the policy."

The idea of a steadily accumulating fund over the duration of the policy was highlighted. It appears likely that this was the final version of the retirement annuity leaflet: the class of business was superseded in 1988. After 30 June 1988, retirement annuity policyholders had the right to pay additional premiums, and the Society was obliged to receive these on policy conditions already established under the old system. By this time the 'fund' representation of the policyholder's interest had been well advertised in the Society's literature. Nothing in that literature would have alerted any policyholder or potential policyholder to the existence of an intention on the part of the Board to take into account the form in which benefits were taken in determining the amount of final bonus. On the contrary the repeated

references to 'fund' growth, associated with the emphasis on the vulnerability of the fund to financial conditions would have indicated that future benefits would have been subject to market conditions but would not otherwise have been liable to change on grounds related to any policy of the Board.

62. The Society's bonuses leaflet dated February 1987 used substantially the same terminology in describing the system generally. These descriptions, taken at face value, expressed the reality of the contract. The investment return was an implicit element in the guaranteed return to policyholders. It was a contractual liability. The sum available for bonus distribution was struck after providing for all guarantees. At this stage the leaflet stated that there was no business written that did not carry the minimum guaranteed return. Illustrations were provided of the application of the 1986 reversionary bonus declaration. The document contained a table of final bonus percentages for endowment and whole life business increasing with time to 25 years and over. In relation to final bonus for pensions, it described a calculation, in the first instance, of a percentage of the amount of declared bonus for each £1000 of basic guaranteed benefit, subject to over-riding limits related to duration. There was no longer a cross-reference to the endowment table.

63. However, the document contained a significant reference to one aspect of practice. The document stated:

> "Where the policy terms provide for interest to apply for the period between the policy anniversary in 1986 and the date on which benefits are payable the final bonus rates calculated as above will be appropriately reduced to take into account the interest contractually payable."

This paragraph illustrated the Society's advertised approach of cancelling out specified contractual benefits by discounting terminal bonus in the particular case in which the contract made provision for interest. As indicated earlier[3] the Board's formal statement of bonuses included a note to this effect that remained in the document after the introduction of a note intended to describe the differential terminal bonus policy. The February 1987 leaflet would not have alerted policyholders to the possibility that other guaranteed rights would have been treated in the same way. Indeed the specification of the particular case would have tended to suggest that there were no other similar cases that required notice.

64. In 1998, Sherlock wrote to policyholders explaining the reduction in the rate of bonus declared at 31 December 1987. He described the bonus system in now conventional terms, emphasising the 'managed fund' concept and the investment policies dictated by it. He commented on management's view that it was appropriate to control the proportion invested in fixed interest assets, so that it was not larger than would normally be considered suitable in a balanced mixed portfolio. In that way, investment strategy would not be unduly constrained by non-investment considerations. He discussed the problems associated with the distribution of capital appreciation, and the need to be careful not to place too great a reliance on capital appreciation in allocating declared bonuses) to policyholders. He described past practice:

> "In the late 1970s and early 1980s high levels of income returns gave rise to increasing levels of declared bonus rates. Since then declared rates have been on a plateau. In the light of current investment conditions your Board has decided that the appropriate course of action is to embark on a strategy of moving declared bonus rates down to be consistent with current levels of income returns. That action does not necessarily imply a reduction in the level of policy benefits, but rather a change in the balance between the 'declared' and 'final' elements in the overall bonus system. The final bonus rates introduced at this declaration mean that policy proceeds in 1988 will be at similar levels to last year, except at the shorter terms."

[3] See chapter 2, paragraph 96.

65. At this stage it is difficult to form a view of policyholders' reactions to this statement in isolation: the representation was that the strategy did not 'necessarily' imply a reduction in the level of policy benefits, but rather a change in the balance between the 'declared' and 'final' elements in the overall bonus system, and at least left open the possibility that the strategy might imply a reduction in the level of policy benefits. But the language used related to global experience, not particular classes of policyholder benefits. It would have been inconsistent with this representation for the amount allocated to terminal bonus to have been vulnerable to variation according to the choice of form of benefit taken at maturity. When it emerged, the differential terminal bonus policy depended on reduction of the final bonus otherwise available where the annuity guarantee was taken. Its effectiveness depended on there being a sufficient sum available as accrued terminal bonus to absorb the reduction. The shift of balance between declared and terminal bonus would have increased the exposure of the retirement annuity policyholder to reduction in total policy proceeds as accumulated on the managed fund approach. There was no suggestion of such a proposal.

66. The bonus notice brought out the total fund guaranteed under the policy, and the amount calculated under the policy terms projected to the illustrated pension age. It stated that if the benefits were payable on 1 April 1988 a lower sum would be due. There was now a change of terminology: terminal bonus was re-designated 'final' bonus. If final bonus were included the sum would be increased. The notice further stated that "The amount of final bonus payable is not guaranteed and it may vary as financial conditions alter". One would have inferred that any reduction in the level of total policy benefits would be a function of the markets. The reference to financial conditions gave colour to the comments in the letter.

67. The 1987 form of bonus notice did not distinguish final bonuses payable according to the form of benefit the policyholder elected to take from among the forms available. Note 5 provided for single reversionary bonus rates on with profits retirement policies irrespective of circumstances. Note 6 warned that the full value of a policy might not be due if a policyholder required to withdraw other than in terms of the contract, a reflection of the long-standing policy of offering no guarantee of surrender values. Bonus notices varied in detail depending on policy form.. Perhaps the most intriguing factor, however, was that the benefits forms did not disclose the annuity at all. On the other hand they did project the policy value forward to 1 April 1988, the bonus vesting date under the new practice, and gave a value for the policy if there were a final bonus at current rates. The paper *With Profits Without Mystery*[4] explained the change[5].

68. Apart from strengthening the notion of the 'managed fund', and the shift towards 'present value' presentation of recurrent single-premium benefits in the bonus notices, there was little else to change policyholders' reasonable expectations in respect of bonus allocation at the end of 1987. 1988 was a year of more dramatic impact on the Society's business. In his statement in the statutory accounts, Professor Smith referred to the transition from retirement annuity contracts to personal pensions. He commented on the opportunity for growth that was presented and had been taken. He explained that growth could be accommodated because of the Society's relatively low cost base. There was a change of bonus policy, favouring

[4] See chapter 4.

[5] Paragraph 3.2.18: "The results of a bonus declaration are presented in the conventional way to policyholders and a number of final bonus scales appropriate to different types of business are published. At the declaration as at 31 December 1987 the effect of the declaration was also shown to policyholders in present value form for all contracts of recurrent single-premium type. That is, the present value of the contractual benefits including declared bonus was shown on bonus notices together with the amount of final bonus which would apply if benefits were payable immediately. It is felt that such a presentation gives clients a helpful insight into how their policy benefits, both consolidated and unconsolidated, are building up."

longer durations. But there was little else to inform members of the implications of change.

69. Leaving aside information obtained from Board and other internal papers, but with the benefit of hindsight, one might have expected that the introduction of personal pensions into the with-profits fund would necessarily have identified a new focus for reasonable expectations, and raised questions whether there were difference as between those classes of policyholders who enjoyed guaranteed annuity and other guaranteed benefits, and the new class of pension policyholders whose contractual benefits were different to a greater or lesser degree. The easiest comparison is between continuing retirement annuity policyholders and new-style personal pension policyholders. In the case of the new class of policyholders, there was an obvious issue relating to the provision of information about the risk, however remote it might have been thought to be, that the guaranteed annuity rights of other participants in the with-profits fund might affect the personal pension policyholders adversely if the annuity guarantees were to come 'into the money'. But so far as the new personal pension policyholders are concerned the search by the inquiry for any indication that there might be an adverse impact on policy proceeds arising from competition between classes has been in vain.

70. There was a material distinction between benefits illustrations and similar materials in use prior to the LAUTRO requirements and thereafter. The notes to LAUTRO illustrations stated:

> "The figures are only examples, none is guaranteed and they do not represent the minimum or maximum amounts. The eventual benefits will depend on how the investments perform and may be more or less than those shown. Do not forget that inflation would reduce what you could buy in the future with the benefits arising. All insurance companies use the same rates to illustrate how funds may be converted into pension income. Your pension income will depend an how the investments perform and on annuity rates at the time you retire."

As required by the regulations, the new forms gave no information about the Society's yields, historical or projected. They reflected the Society's expenses rates, but these were set against standard projections of growth. The form brought out the net contributions, and the projected fund value with specification of the tax-free sum on commutation and the balance to be paid for an annuity. Fund value under this form was the sole expression of future value, and on a wholly hypothetical basis. However, no policyholder or potential policyholder would have understood from the Society's literature that there was a risk of conflict of interests with any other class of policyholder.

71. Sherlock sent a letter to retirement annuity policyholders in February 1989 in respect of the year 1988. The inquiry also examined bonus declaration forms and covering letters relating to the year to 31 December 1988. The covering letters include those referred to by Corley paragraph 56 as setting out the Equitable philosophy on bonuses. None of the documents contained any hint of the differential final bonus policy that was to emerge later. Sherlock's letter discussed the characteristics of the Society stemming from its mutual status reasonably comprehensively. He said:

> "It follows from the above comments that the benefits under our with-profits policies depend primarily on the successful investment of the premiums and only marginally on profit arising from other policies. Further, we aim to ensure that the total proceeds members receive reflect the investment returns on the fund during the course of the policy. However, the essential nature of with-profits business, namely the steady addition of declared and, therefore, guaranteed bonuses, means that there is no automatic link between asset values and policy benefits. In simple terms there is a smoothing of asset values over time and of the peaks and troughs through the bonus system. ... .

> Although the with-profits system contains within it an essential element of smoothing, nevertheless the Society's practice is to limit that to evening out peaks and troughs and unduly sharp changes from year to year. Specifically, we do not set out to build up excessive 'free reserves', which some describe as 'strength'. This could only be done by deliberately, or worse still, accidentally, withholding part of the return due to members for the benefit of their successors. What is important is that there should be sufficient strength to avoid any unplanned constraints on investment freedom or growth in business, whilst still giving 'full value' return to existing members."

72. In this letter, Sherlock informed with-profits policyholders, including retirement annuity policyholders, that the policies carried a premium much higher than was needed to support guaranteed benefits. The comment was general, applying to all with-profits business without differentiation between policy types. The clear perception at the time was that the premium bases provided capital for investment over and above the provision of the guaranteed benefits. In providing working capital and financing future growth the with-profits policyholders contributed to a continuing process, "each generation being financed by its predecessor and, in its turn, financing its successor". Some degree of inter-generational transfer was inherent in that process: it was a question of degree. But in relation to later developments the most significant factor is the statement that premiums were much higher than required to support guaranteed benefits. At this stage the last policies written under the superseded revenue legislation had been issued, and the premium guarantees applicable to those policies had been settled. Policyholders were entitled to continue to make contributions on those terms until maturity. I consider that this contemporary statement of the sufficiency of the premium bases to cover policy guarantees is acceptable evidence of the position that was obtained in fact. Later contradictory statements to the effect that annuity guarantees had not been paid for are unreliable. The policy of giving 'full value' to all policyholders, subject to smoothing, was affirmative of earlier policy statements.

73. The letter made explicit the philosophy of providing products other than with-profits at low cost, and taking a low return on these, a practice that drew criticism in the debate following *With Profits Without Mystery*. Read as a whole, the letter was a core statement of policy that would have instructed policyholders' understanding of the business policies and practices of the Board at a crucial time in the development of the Society's business. The Board's smoothing policy was stated, though in terms that communicated little about the range of peaks and troughs that might be accommodated by it. The holders of with-profits contracts were informed in clear and unqualified terms that they were paying for policy guarantees and in addition providing working capital for expansion. Following this intimation it would have required a clear contrary statement to indicate to relevant policyholders that they were under a contingent obligation to 'pay for' contractual guarantees from terminal bonus that would otherwise accrue to their benefit. Generally, the statement would have encouraged members to assume that management would report to them any matter of significance affecting their entitlement.

74. The bonus notice was in the same form as the previous year. In respect of final bonus, the notes stated:

> "The amount of final bonus payable is not guaranteed and it may vary as financial conditions alter. When the benefits are ultimately taken the amount of final bonus payable could be less than the final bonus included in the above present value."

Having regard to the commitment to openness of communication, it might have been expected that the communications with policyholders and prospective policyholders at this time, part of a period of intense activity, in the accounts, and other publications, would have included full information on matters such as the annuity guarantees available on the retirement annuity and other older pensions business, but absent from personal pensions, for example, as part of the process of ensuring

that all policyholders knew about their policies and the Society's business. But the accounts themselves did not disclose any relevant information. The bonus statements reflected the same emphasis on the balance between guaranteed and un-guaranteed benefits, related to investment opportunity, as in the previous year. There was a similar statement about the scope for variation of the final bonus rate. Apart from immaterial changes of emphasis, there was nothing that would have made a change in the reasonable expectations of existing policyholders and nothing to have alerted new and prospective policyholders to material changes of direction.

75. In his statement in the statutory accounts for 1989, the president repeated the substance of his general policy statement of 1986, and, in particular that the Board's policy was "to hold back the minimum by way of reserve consistent with prudent management." In the statement of bonuses, management set out the rates of bonuses payable on a range of products. In relation to final bonus it was explained that under recurrent single premium contracts (which included retirement annuities for the self-employed) the policy was essentially one of building up a cash fund, although the contractual benefits might be expressed as payable at some future date in some other form. It was said that part of that fund at any time would consist of the value of guaranteed benefits (those secured by the premiums paid and declared bonus additions). The remaining, un-guaranteed, part represented the final bonus that would be paid if the policy benefits became payable immediately. It was not suggested that if the sum were paid immediately it would vary in value according to the form of benefits selected.

76. The management report on the 1989 accounts drew attention to one aspect of new business that was potentially significant. It stated that new business included the proceeds of certain pension policies issued by the Society, which had been used at retirement to buy policies with the Society. It commented that:

> "Clearly many policyholders feel that a combination of the with-profits bond and with-profits annuity is a natural use of the proceeds of a with-profits pension or other savings policy.."

The practice referred to involved the reinvestment of commutation proceeds in a with-profits bond with the annuity taking with-profits form. Members would have understood that the application of maturity proceeds in the purchase of substituted benefits was treated as a claim and as new business.

77. The statement of bonuses in the accounts reflected the major change in bonus practice introduced in 1989 that was to give rise to controversy later. It included reference to the new system and the "accumulating fund" nature of the contract as it was now envisaged. The distinction between the guaranteed part and the non-guaranteed part of policy benefits was described, and policyholders were informed of the idea that final bonus was a difference expressed by reference to total value and the guaranteed benefits. This change of approach was a material innovation on policyholders' reasonable expectations. It was described in *With Profits Without Mystery*, and it was with this change of format that the Society began to create the widely held expectation that policy value represented aggregate benefits, and that the differentiation was related primarily if not exclusively to investment considerations.

78. Viewed in isolation from the other communications with policyholders at this stage, the statements in the published accounts expressing the 'accumulating fund' characterisation of the policyholder's interest could have given rise to misunderstanding. But there were other documents in issue at the same time and it is necessary to have regard to the total range. Sherlock's 'dear policyholder' letter of February 1990, relating to the 1989 bonus declaration, was one of those referred to by Corley at paragraph 56. It carried the process of defining the with-profits 'philosophy' further. It set out the basic principles of with-profits business as practised by the Society. Full distribution was described. He stated:

"The Society's with-profits contracts contain a basic guaranteed level of benefits, expressed as, for example, a guaranteed amount of fund. A certain level of investment return is needed to cover the build-up of these guaranteed benefits. The return in excess of that basic level is available for distribution as bonuses.

... Part of that excess is translated each year into a 'declared bonus'. Such bonuses are additional, fully guaranteed, benefits and are added to all previously guaranteed benefits. In this way, the annual addition of declared bonuses provides an increasing underlying value below which the ultimate benefits cannot fall. The accumulated amount of the basic guaranteed benefits and declared bonuses represents the consolidated value of the policy benefits.

The balance of the overall return is carried forward unconsolidated but is credited immediately as final bonus when benefits become payable under the terms of the policy. The retention of part of the accumulated total policy value in unconsolidated form is a vital ingredient in the operation of with-profits business. In that way the Society retains the flexibility to manage its investments in a way compatible with achieving the best results it can for the with-profits policyholders.

It should be emphasised that, while both consolidated and unconsolidated benefits would be paid if they became due now, only the consolidated benefits are guaranteed for the future. The amount of final bonus ultimately paid will depend on the future experience of the Society; it could be lower as well as higher than the current amount."

79. Having introduced terminology to distinguish the guaranteed benefits, "the consolidated value of the policy benefits", from the "unconsolidated" surplus balance carried forward, the letter turned to the current declaration. In that context the following further general observations were made:

"Previously the Society has determined the "unconsolidated", or "final bonus" element in total policy values by the use of specific scales of rates. This year, we have simplified our approach by determining the end of year policy values by bringing forward last year's values (if any) and subsequent premiums at a rate of growth determined by the Directors. The final bonus element is now simply the difference between the total policy benefits and the consolidated element (i.e. basic guaranteed benefits and declared bonuses)."

In summary Sherlock stated:

"In summary, the earnings allocated to with-profits contracts can be regarded in three ways:

(1) The first 'slice' of earnings provides the growth in basic benefits guaranteed by the contract terms.

(2) The next 'slice' of earnings is used to increase the guaranteed benefits by the allocation of declared bonuses each year.

(3) The balance of the earnings available is granted as final bonus.

The latest development of the Society's bonus systems brings out these three uses of the allocated earnings in an explicit manner."

The notes attached to the statement of benefits made no difference to that picture. The statement continued to state the amount of a final bonus, at current rates, if one were paid. The bonus notices for the 1989 declaration were in the same form as 1988. The new system appears not to have been reflected in the notices until the following year.

80. In attempting to make its bonus structures explicit, the Society had introduced factors that could only serve to confuse. The 'accumulating fund' that was central to the presentation implied a degree of homogeneity inconsistent with

the combination of elements with wholly distinguishable characteristics. Similarly, the notion of an overall rate of growth combining consolidated and unconsolidated elements again implied a combination of incompatible elements. The potential for confusion appears, in retrospect, in the explanations offered. In the accounts, in dealing with personal pensions, the accumulating fund, described as 'the total policy value', was calculated for a single premium paid one year previously by applying the total growth rate for the year to the premium (in that case the guaranteed fund at the beginning of the year). The guaranteed fund was calculated by applying the guaranteed and bonus rates applicable to the premium. The difference was said to be the final bonus. There was a similar illustration for a bond[6]. On this approach, final bonus was not calculated independently: it was derived from the accumulating fund which, on that approach, had to derive its meaning and effect from the application of the annual growth rate.

81. Sherlock's statement was superficially comprehensive, and clearer than the management statement in the accounts, though it also emphasised the rate of growth as the critical factor. On his presentation, the unconsolidated balance of benefits was not guaranteed and was liable to vary depending on the future experience of the Society, subject to smoothing. The sense of the letter was that bonuses, of varying types, were used to pay out the averaged returns, income and gains, actually achieved above the basic guaranteed policy benefits, over the life of the policy. The letter reflected the view that the bonus fund was ascertained after providing for all guarantees. Read subject to all of the qualifications found in the letter, the representation was that each policyholder would find in the statement of benefits sent with it a sum described as "total policy benefits", part of which was "consolidated" and part "unconsolidated". At maturity the unconsolidated part might be higher or lower than the current amount specified. If policyholders' reasonable expectations were to be measured exclusively by the standards of a financially sophisticated expert the nuances would no doubt have been clear. But I tend to think that if such a person had to express a view on the impact made by all of this information on a typical policyholder lacking such skills he would have been forced to conclude that it was confusing.

82. However, in any event, the factors qualifying the policyholder's expectations of receiving final bonus in terms of the notices he received were clear: there was no qualification of the policyholder's right to the eventual sum other than that dictated by the vagaries of the market. There was the added complication that it could not have been easy for a policyholder to understand the basis on which the Board had proceeded in dealing with terminal bonus in and after 1989. Article 65(1) dealt with declared bonus. Article 65(2) provided power to pay interim or additional or special bonuses on claims between valuations. The amount was discretionary, in terms of article 65(3). But the power was a power to pay, and was exercisable by the Board. To be regular, the resolution on the total rate of growth was, and could only be, an exercise of the power under article 65(2), with the designation of declared bonus an exercise of the power under article 65(1). It is far from clear how the new system could be accommodated, however. If the resolution were an application of article 65 (2), any subsequent variation of the accrued final bonus element would, at least, have required a resolution of the Board not to pay what had been intimated, but to pay on the substituted basis. However, policyholders would have been entitled to proceed on the assumption that the Board was satisfied that it had power to act as it intended.

[6] Warren 2 (see chapter 8), at paragraph 36, says that in this report there was an example in which the final bonus was adjusted. It appears that the writers of the second joint opinion misunderstood the material. It did not refer to maturity. It simply illustrated the application of policy where the total uplift was 11%. Further the final bonus illustrations related to personal pensions which only came into effect on the abandonment of the guaranteed annuity form of contract. It appears that the writers confused guaranteed investment returns, which continued, with the guaranteed conversion rates in possession implicit in the older form of contract.

83. Taking account of recent publications and policyholder communications, material elements in policyholders' and potential policyholders' reasonable expectations at this stage, as the Society entered the 1990s, included the following:

i. It would have been understood from at least 1987 that surplus available for bonus was ascertained after providing for policy guarantees.

ii. From 1986 it would have been expected that declared bonuses were a fixed liability that must be paid whatever the level of financial markets at the date of payment.

iii. From 1987 it would have been expected that there would be limited resort to capital appreciation to support declared bonuses, and a downward trend in declared bonuses.

iv. It would have been understood that variability of the terminal bonus was related to prevailing financial conditions, the amount depending on the future experience of the Society.

v. It would not have expected that the exercise of a contractual right would be a factor in the determination of final bonus.

vi. From 1989, the policyholder could reasonably expect that the annual statement of policy value reflected the build up of a cash fund, subject to the vagaries of the market.

84. There was an edition of the 'Bonuses' leaflet dated July 1990. It discussed bonus policy in familiar terms. In relation to recurrent single contribution contracts the system was described. The 'guarantees under the policy' comprised the contributions, less expenses accumulated at the guaranteed rate of interest, if any specified explicitly or implicitly in the policy. Declared bonus was an additional rate of guaranteed accumulation determined and applied retrospectively. The leaflet stated that final bonuses were calculated so as to top up the growth arising from the policy guarantees and the declared bonus rate for the year; that final bonuses did not add to the guaranteed element of the contract, and that the final bonus element of a policy could be varied up or down in future. It described the additional final bonus paid for the final period to maturity from the valuation date. On its terms the leaflet would have informed policyholders and prospective policyholders that the accrued final bonus was variable. But it would have reinforced the view that the final bonus was an element of the growth arising on the policy.

85. On 31 August 1990, the Society published a 'With-Profits Guide' in accordance with LAUTRO rules. Chapter F of the guide dealt with "Recent bonus policy". It described the full distribution policy. It described the Society's approach to final bonus in apparently unambiguous terms:

> "The approach to final bonus is that the investment reserve, which is the excess of assets over liabilities, is averaged over time and notionally apportioned amongst the with profits policyholders in the fund at the current time in direct relation to the liabilities under their policies."

As discussed in chapter 6, this statement does not reflect the reality of bonus allocation practice as I have found it. But on its terms, the statement excluded anything of the nature of a differential final bonus policy. The liability to policyholders, as described by the Society, was a function of net premium investment, investment roll-up and declared bonuses. Notional apportionment in direct relation to liabilities was fundamentally incompatible with variation according to the form of benefits selected. Positively, this was a representation that the amounts of final bonus were directly related to the investment reserve, subject to averaging over time.

86. The guide illustrated the operation of the Society's bonus policy in relation to total growth on a personal pension policy for 1989:

> "..the guaranteed interest rate for the year was 3½%, declared bonus was 7½% (on the 3 ½% as well as the original amount), bringing the return up to about 11¼%. The balance was the final bonus credited for the year. The final bonus is, of course, not a guaranteed element and could be reduced in future."

The guide emphasised that the Society's basic approach to with-profits business was to attempt to be fair to policyholders with all types of contracts and over all durations. It stated:

> "The investment returns on the underlying assets are averaged and smoothed sufficiently so that, through the declared bonus system, the with-profits policyholders' expectation of a gradual, and non erratic, build up of policy values over the duration of the policy is met. Final bonuses, which pass on a final share of profits when the benefits become payable, may be less stable, but even so violent fluctuations are avoided where possible. ..."

The reader would have been entitled to conclude that the guide was intended to satisfy the Society's regulatory obligation[7] in describing its products.

87. The author of the guide did not distinguish between annuity policyholders with annuity guarantees and others. In that situation the liabilities under the retirement annuity policies (the first construction issue in *Hyman*) would have had to be valued; the residue of projected surplus value would have been available to with-profits policyholders generally; and the apportionment of the investment reserve would have been advantageous to the retirement annuity members. Negatively, there was nothing to indicate a differential final bonus policy depending on which contractual benefit was taken by a policyholder having a choice of alternative benefits including an annuity guarantee. The treatment of the guaranteed rate of investment return in personal pension business was clear and specific. It was a guarantee taken into account before the application of bonus, and the reversionary bonus took effect on the liability, including the 3.5% accrued investment return.

88. Smith's statement in the 1990 accounts did not contain any comments that would have altered or added to policyholders' reasonable expectations. It suggested continuing progress. He reported the retirement of Sherlock and Ranson's appointment as general manager. On a more general level, he commented that increasing numbers of policyholders were reaching retirement and would be faced with a much wider range of options than previously. One implication was that some claims on maturing policies might be met by switching to other forms of contract rather than payment in terms of existing contracts. The bonus system was not dealt with in detail. There was a brief reference in the directors' report. In terms of policyholders' expectations relative to bonus, the report was neutral in tone. However, the Society's ability, and wish, to declare bonus, and to make an allotment in the prevailing financial climate, were factors that would have had a material impact on policyholders' reasonable expectations relating to the likely response to future years of poor returns.

89. Sherlock's 'dear policyholder' letter for the year to 31 December 1990 explained that no changes to the bonus systems were being made. He commented that the averaging of investment performance and the smoothing of short-term fluctuations were fundamental features of with-profits business, and:

> "Accordingly - and in spite of significant falls in world stock markets - I am delighted to tell you that the total rate of growth for recurrent single premium policies such as pensions, school fees and annuities in respect of 1990 is 12%. The rate for comparable life assurance policies such as bonds is 11½%, with other life policies being treated in a similar manner."

Policyholders, aware of the state of the markets, would have been entitled to expect that the Society had the strength to sustain significant losses and still maintain high levels of bonus allocation.

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[7] The LAUTRO rules.

90. The notice of the retirement annuity policy bonus declaration for the year ending 31 December 1990 gave effect to the structural changes previously intimated, though the terminology of 'consolidated' and 'unconsolidated' benefits was not used. The statement brought out the guaranteed fund value by the aggregating balances brought forward, new investment and new guaranteed interest and reversionary bonus credits, bringing out the "New guaranteed fund value on 1 April 1991". To that was added the final bonus addition at 1 April 1991, to give a "Total fund value on 1 April 1991". The notes stated that a comparison of the fund value on 1 April from year to year would show how the investment was progressing. The notes stated explicitly that the guaranteed benefits within the policy would be increased by way of a final bonus should benefits be payable prior to 1 April 1991. This point was also included in the 1991 and 1992 statements but notably not in the statement for 1993. Note 8 stated:

> "The amount of final bonus payable is not guaranteed and it may vary as financial conditions alter. When the benefits are ultimately taken, the amount of final bonus payable could be less than the final bonus included in the 1 April 1991 fund value."

Liability to variation was therefore repeated, but with reference to changes in financial conditions.

91. The information provided to policyholders therefore identified the "fund value" in terms of the aggregate of guaranteed and non-guaranteed benefits. The description of "total" rates of growth remained less than transparent. The projected annuity was not disclosed. The sole qualification relating to final bonus was that it might vary as financial conditions altered, and could be less at maturity than indicated in the notice. There would have been few material changes to policyholders' reasonable expectations arising from these communications. A careful reader would have inferred that at maturity prior to 1 April following the advertised rate of terminal bonus forward was effectively guaranteed. But the general position brought forward would have been more significant: terminal bonus was part of the bonus structure and would be paid subject to market conditions at maturity. The forms of illustrations on policy endorsements issued on payment of additional premiums and in statements of fund values issued on request would not have altered perceptions.

92. The 1991 accounts did not change the position. The 'dear policyholder' letter accompanying the bonus notices was now signed by Ranson[8]. Its opening paragraph stated:

> "Last year we issued a letter with bonus notices and annual statements explaining that, despite a year of negative investment returns in 1990, we had felt able to announce bonuses which represented an attractive build-up of policy values. Such an outcome exemplifies the advantages of the with-profits system – in particular the smoothing of short-term fluctuations in investment conditions"

Sherlock's February 1991 letter had not disclosed that the Society had had negative returns in 1990.

93. The total growth rates for the current year were maintained at the previous year's level. The 'dear policyholder' letter described the approach to bonus:

> "It is, of course, the overall rate of return granted over the years which affects policy results. Part of that return is allotted in a consolidated form, traditionally called 'reversionary' or 'declared' bonus. This means that it becomes a guaranteed addition to the policy benefits. The balance, which we call 'final bonus' and others call 'interim and terminal bonus' is not guaranteed, builds up continuously and is only payable when the policy benefits become contractually payable. The Directors reserve the right

[8] This letter was not referred to by Corley in paragraph 56, but it was of the same series.

> subsequently to change the amount of final bonus attaching at a declaration date if financial conditions make such a course of action appropriate. To date, such a change has not been made."

This formulation increased confusion by referring to final bonus 'attaching' at a declaration date, subject to change. But it made clear that 'financial conditions' were the trigger for changes to the final bonus. The statement reaffirmed that such a change had not been made, and drew attention to the Society's past performance as a material consideration. The wording of the letter had changed considerably from the 1990 version. The mood was less ebullient. Looking ahead Ranson noted that investment conditions were uncertain. However, there was no clear indication that the unconsolidated part of the total projected value of the 'fund' was becoming speculative.

94. The statement of benefits for retirement annuity policyholders followed the previous year's format, with a statement of "Total fund value", qualified by note. The notice provided no information about the annuity projection. The annual statement for personal pension plans indicated the total funds that would be available on maturity at 1 April 1991, including final bonus. It stated that the date of I April 1992 was chosen because that was the date at which the new bonus, allocated at the 1991 declaration, would "become attaching to benefits then still in force", and that a comparison of the fund value on 1 April from year to year would show how the investment was progressing. The notes commented, inter alia:

> "(1) The updated guaranteed benefits (including declared bonus added) are guaranteed whatever the investment conditions in the future. The final bonus addition reflects current investment conditions and is not guaranteed. It can be expected to vary in the future."

One had again the discordant references to 'attachment' and variability. In the current letter the scope for variation in response to financial conditions was described more loosely than previously. But read in sequence with the earlier letters it would have communicated the same message: the final bonus was a reflection of current investment conditions, and *in that context* it might change. On another topic, the notes indicated that the Society reserved the right, when appropriate, to adjust transfer values for the purpose of maintaining reasonable consistency with underlying asset values. This was a change of policy. Generally the Society had allowed the full policy value to be transferred.

95. In his statement in the 1992 Accounts the president commented on full distribution, and that it would be incompatible with the Society's culture to hold back benefits from one generation to build up reserves for a future generation. He stated:

> "As we say in our literature, for new policyholders future bonuses must depend primarily on the investment of new premiums. Any deliberate cross subsidies between generations would not be 'equitable'."

Cross subsidy could occur in either direction: over-distribution to a current generation at the expense of a future generation would imply that new policyholders would not receive the benefit of the investment of their new premiums. The reader would have been entitled to infer from the general condemnation of cross subsidies that the Society avoided both types of practice, subject to some degree of smoothing.

96. In the with-profits guide dated 1 July 1992, smoothing was explained. Valuation was explained. The bonus system was explained in very much the same terms as in the previous year. No new or varied policyholders' reasonable expectations would have been identified. Ranson's 'dear policyholder' letter of March 1993 was concerned in large part with explaining the bonus declaration in terms of investment returns. In that respect it gave considerably more financial information than had been given in previous years. It described the three levels of appropriation set out in the 1990 letter for the 1989 distribution, in altered language. It emphasised the conditional nature of the final bonus illustration. There was no

reference to any conditions affecting or that might affect entitlement to final bonus, or the rates at which it might be credited. However, there was no reference to investment conditions either. The letter stated that 'for many years' the directors had taken into consideration the redemption yields on gilts when determining declared bonuses. Since these had fallen, it was said that the directors had decided to reduce the level of declared bonuses.

97. The description of the policy background on this occasion became standard for a period:

> "With-profits contracts provide the opportunity for investing in a managed fund of assets including equities, property and fixed-interest stock. The with-profits approach has the unique feature of smoothing out the fluctuations in the investment return which are associated with such assets.
>
> Under that approach, the Society determines an overall rate of return for the calendar year, which is distributed in the following three ways.
>
> 1. By accumulating, at the minimum rate of interest guaranteed either explicitly or implicitly in the policy, the part of the benefits which was guaranteed at the beginning of the year, plus further contributions less a deduction towards expenses.
> 2. By annual declared bonus additions which, once added, increase the guaranteed benefits under the policy.
> 3. By passing on the balance of the overall rate of return for the year through final bonus, which does not add to the guarantees under the contract. The amount of final bonus is illustrated on the statement and, on request, from time to time but the amount is only finally determined at the time of claim.
>
> The return passed on to date through guaranteed interest and declared bonuses can be regarded as consolidated for the purpose of determining payouts on the happening of certain events as described in the policy. The return passed on through final bonus can be regarded as unconsolidated as its amount is not guaranteed and could fluctuate in the future."

98. The letter explained the 'overall rate of return' was 'credited' by way of a basic guaranteed rate of interest, declared bonus rate for 1992, and "final bonus which tops up the growth arising from the guarantees and declared bonus rate of the year to the overall rate or return". But an informed policyholder would have understood that the guaranteed investment return was part of the total return without being bonus. The distinction that the final bonus was not consolidated until the time a claim was made was set out. The language had also changed. There was no mention that 'financial conditions' were the deciding factor in the adjustment of final bonus, either directly as in 1991 and earlier letters, or inferentially as in 1992. However, that factor re-emerged in the notes to the bonus notice.

99. Another feature of the letter was a distinction drawn in relation to benefits according to the date of contributions. The overall rate of return for 1992 applied to total benefits on recurrent single contribution pension contracts was:

> For benefits purchased up to 31 December 1991: 10%
>
> For benefits purchased up to 31 December 1992: 12%

The discrimination of bonus treatment for benefits received at different dates was said to be a recognition of the more favourable investment conditions that were obtained in 1992. The reasoning as published was obscure, and the policy cannot readily be reconciled with the Society's general published view of the with-profits fund as a unit in which risks were shared. One might rather look for a different motivation for the discrimination, such as marketing. The policy encouraged additional contributions.

100. The retirement annuity policy bonus statement for year ending 31 December 1992 reflected changes in format. There was an introductory statement that:

> 'The following statement shows the fund that would be available if retirement benefits became payable on 1 April 1993, taking account of premiums processed up to and including 31 December 1992. The date of 1 April 1993 is chosen because that is the date at which the new bonus, allocated at the 1992 declaration, will become attaching to benefits then still in force. Where retirement benefits become payable before 1 April 1993, the appropriate level of total proceeds will be given by means of final bonus additions. A comparison of the fund value on 1 April from year to year will show how the investment is progressing.'

This formulation appears to have been taken from the form previously in use for personal pension plan benefits statements. Note 2 stated that final bonus reflected current investment conditions and was not guaranteed. It could be expected to vary in the future. This was a new provision in the notes section. But it expressed afresh the representation that final bonus was related directly to current investment conditions and it was in that context said that it could be expected to vary in the future. The formulation also was apparently taken from the personal pension plan annual statement for 1991. Some other factors were made more explicit:

> "3. Under the contractual terms, the benefits are payable on the happening of certain events, such as retirement. The values of the benefits shown on 1 April 1993 would be paid if such an event took place on that date, and if the final bonus rates are maintained at the current rates. If the benefits are taken in any other circumstances, such as transfer, there is no guarantee whatsoever."

The increasing weight of the statement emphasised that non-contractual events, such as surrender, would not attract the full final bonus.

101. The format changed again in the 1994 forms for the 1993 declaration. It has to be borne in mind that in December 1993 the Board had resolved to vary the notes to the February 1992 bonus declaration, and in February 1994 had adopted notes for the 1993 declaration that gave expression to the differential final bonus policy in relation to annuity guarantee contracts that was later to become controversial. In November 1993 Ranson had informed regulators and GAD that policyholders with annuity guarantees were expected to waive their contractual rights because they had been given the benefit of modern policy benefits. The 1994 communications provided the first opportunity to advise in force policyholders of these events. In the case of recurrent single premium business each year presented a fresh opportunity to invest, with the Society or other providers, up to the permitted maximum contribution. In these circumstances the terms of the communications had particular significance.

102. Both in the retirement annuity statement form and in the personal pensions form of annual statement, Note 1 stated:

> "The total value as at 31 December 1992 was calculated by discounting the value on 1 April 1993 (shown on last year's statement) for three months at the interim overall rate of return which applied on 1 April 1993.
>
> The total value as at 31 December 1993 has been calculated by rolling up the total value as at 31 December 1992 at the overall rate of return actually allotted for 1993 and accumulating any benefits secured by premiums paid during 1993 at the rate for the appropriate periods up to 31 December 1993. The overall growth for 1993 is made up of "guaranteed interest and bonus declared in 1993" and "increase in final bonus".
>
> The bonus declared for the year ended 31 December 1993 is formally added to policies on 1 April 1994.

> The total fund value shown as applying on 1 April 1994 is the value as at 31 December 1993 rolled up for the three months at the interim overall rate of return which will apply on 1 April 1994..."

103. Investment return guarantees and declared bonus were presented as one value, effectively concealing the variations that existed between policy classes. Note 2 contained the reservation of the right to vary non-guaranteed benefits. It is inconceivable that any policyholder accustomed to reading such forms of reservation would have anticipated variation on any basis other than one related to current market conditions. Overall, there would have been no significant change in policyholders' reasonable expectations. The significant policy decisions implied in the December 1993 and February 1994 resolutions adopting the bonus declaration notes were not communicated to policyholders.

104. Smith delivered his final report as president in the 1993 statutory accounts. He commented on the benchmarking of declared bonus to levels broadly supportable by fixed-interest securities at current market rates of interest. He indicated the basis on which rates had been fixed. He said nothing that would have disclosed the differential final bonus policy. The directors' report repeated the story, with illustrations. This was a critical year. At the year-end the annuity guarantees were 'in the money' according to the Annuity Bureau table[9]. By the date of the president's report, 23 March, the market was recovering. It would have recovered more or less by the date of the notice calling the annual general meeting, and totally by the date of the AGM. The total absence of any comment on the policy is significant, given the Society's commitment to open communication with its policyholders.

105. The with-profits guide dated 1 May 1993 was in terms similar to the previous year's publication. The 'dear policyholder' letter dated February 1994 followed generally the format of Ranson's letter for 1992. Its most significant feature for present purposes was again the absence of reference to factors that might affect final bonus other than those dependent on market conditions. On this occasion, there was nothing in the notes to the bonus notices that bore on this issue. The relevant note stated:

> "The total fund values include amounts of final bonus which are not guaranteed and may vary up or down. The fund available at retirement on or after 1 April 1994 may therefore be less than the total value shown, but would not be less than the guaranteed value."

Whatever meaning might have been ascribed to this language in isolation, there was nothing to indicate a material change of direction in the Board's thinking on the calculation of final bonus. The second sentence reflected one factor in the eventual application of the differential final bonus policy. The reference to financial conditions had gone. But no policyholder could have identified in the communications any reference to the differential final bonus policy. The letter discussed falling interest rates in relation to the current distribution: the topic was not totally ignored. Omitting a description of the differential final bonus policy cannot be construed as a mistake. The failure to make any comment on the Board's decisions raises serious questions about the communication of policy to members and policyholders.

106. New benefit statement forms were introduced at this time. Until 1991, the form had referred to the bonus declaration and set out a statement of benefits accruing on the policy. From 1992, the form was of an 'Annual Statement' that tended to give greater emphasis to the notion of a fund increasing year on year by the addition of benefits. The layout of 'With-Profits Retirement Benefits' statement was altered in the 1994 notice based on the 1993 results. The guaranteed benefits, the final bonus and total benefits were now all presented in columnar form. Fund values for all three components could now be compared with the previous year's value (previous statements displayed the guaranteed value only). The wording of the notes changed.

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[9] Corley appendix 2, page 7.

107. The new layout and wording of this statement presented three different values as at 31 December 1993. The total fund value was divided between the guaranteed benefits and the final bonus. The notes were developed from the 1992 form. But there was no reference to any relationship between the possible reduction and the rights of the guaranteed annuity policyholders. There was nothing expressly to alert the reader to any possible problem. In relation to non-contractual terminations the notes stated:

> "In circumstances other than those covered by the policy conditions, for example transfer to another pension provider, the Society reserves the right to calculate the fund in a different way."

This was a repetition of the long-standing policy in respect of surrenders and other non-contractual terminations. But expression of one set of circumstances in which the Society reserved the right to calculate the fund in a different way would have tended to indicate that there was no set of circumstances in which the calculation might differ at contractual maturity. There were no material changes in policyholders' reasonable expectations. In particular, no policyholder would have had a reasonable expectation of an imbalance in the computation of interests in bonus as between guaranteed annuity policyholders and policyholders who did not have the benefit of an annuity guarantee.

108. The forms of illustration of projected benefits used in 1994 applied the LAUTRO assumptions. The notes explained the basis of those rates, and of the assumptions made, the impact of inflation and other factors noted previously. The notes did not make reference to the Society's treatment of annuity guarantees and final bonus. The inquiry recovered correspondence with a retirement annuity policyholder illustrating the Society's practice at the time. The policyholder was sent a range of projections with a reference date of 18 March 1994. The Society illustrated annuity payments, with-profits and without-profits, and annuity payments with a minimum duration of five years. The information provided made no reference to annuity guarantees in terms of the original policy.

109. A new edition of the Society's with-profits guide was published on 1 May 1994. In view of its date this again was an important document. It rehearsed the 'managed fund' approach, and smoothing of earnings and asset values. It described the build up of benefits incorporating the contractual guarantees, and bonuses. It distinguished guaranteed bonuses. In relation to final bonus it stated:

> "A final share of profits is also allotted at the point the benefits become contractually payable. The rates of bonus used to allocate a final share of profits are determined by the Directors from time to time acting on the advice of the Actuary."

Full distribution was discussed. Overall bonus policy was described thus:

> "The Society's approach to the smoothing of investment returns in their transformation into bonus additions is twofold. Firstly, there should be no deliberate and excessive holding back of earnings to benefit future policyholders at the expense of current policyholders. Secondly, changes in bonus rates, whether declared or final, should reflect the underlying trend of investment returns rather than mirror short-term fluctuations. In other words, changes should be gradual whenever circumstances permit."

110. The guide discussed recent bonus policy, giving emphasis to full distribution, the characteristics of the declared bonus, and the final bonus. It stated:

> "The approach to final bonus is that the investment reserve, which is the excess of assets over liabilities, is averaged over time and notionally apportioned amongst the with-profits policyholders in the fund at the current time in direct relation to the liabilities under their policies.
>
> The intention is to avoid too great a volatility in bonuses by smoothing and averaging. Whilst declared bonuses can be expected to be relatively stable,

final bonuses may fluctuate rather more because they are the balancing item in the overall return.."

111. It distinguished 'actual' returns, the overall gross returns on the Society's funds at market value each year, and 'allocated' returns, the total gross overall rates of return on which total bonuses to policyholders were based. It stated:

"It is a fundamental principle underlying the way the Society operates its business that the Society attempts to be fair to policyholders with contracts for all different types and durations. Thus, for example, results for policies under which returns are taxed as compared with those under which returns are tax free, bear a reasonable and equitable relationship with each other. In addition, the returns to the policyholder reflect the size and the incidence of the premiums or contributions paid, and the prevailing investment climate over the duration of the contract.

112. In addition, the leaflet set out policy on payments:

"The Society's contracts provide for the full value of the benefits to be paid out in a wide range of contractual circumstances. Where an individual policyholder leaves the fund under non-contractual circumstances, for example, on early surrender or transfer, the surrender or transfer value basis is not guaranteed. We attempt to pay out full value if financial conditions permit. Where there is evidence of selection against the office, the surrender or transfer value in respect of benefits purchased in 1993 or earlier is reduced to take account of the underlying asset values in circumstances where asset values have declined since 31 December 1993. No attempt is made, however, to generate profits from, for example, early surrenders by imposing penalties which can then be used to increase maturity proceeds."

113. In terms of positive content, much of the substance of the guide remained the same as the previous edition. Additional information was provided on smoothing over the period 1989 to 1993, comparing the actual returns on the Society's funds with the allocated returns. But the features of importance were presented in broadly the same way. Final bonus was 'not a guaranteed element and could be reduced in future'. No class of business was differentiated. If there had been an intention to inform policyholders of the Board's policy relating to the differential final bonus it must have been departed from[10].

114. The documents relating to the 1994 declaration varied. One form remained broadly similar to earlier forms, commenting on the managed fund and smoothing, the fixing of an overall rate of return for the year and its distribution. In relation to final bonus it stated that the distribution passed on

" ...the balance of the overall rate of return for the year through final bonus, which does not add to the guarantees under the contract. The amount of final bonus is illustrated on the statement and, on request, from time to time but the amount is only finally determined at the time of claim."

Another form stated that final bonus passed on

"...the balance of the overall rate of return for the year through final bonus, which does not add to the guarantees under the contract. The amount of final bonus is illustrated on the statement."

In other respects the statements were similar, concentrating on the Society's general bonus policy, economic conditions, and the amount of overall return. In terms of detail the letters were considerably less explicit than the previous year's letter. There was no table analysing the application of the overall return, for example. The letter

[10] It is stated in Corley that Equitable's Board confirmed a differential final bonus policy, and that policyholders who retired in the winter of 1993/4 may actually have been credited with a reduced terminal bonus. It is also stated that the directors were preparing to communicate the policy of selective reduction in terminal bonus in the spring of 1994 when the market changed again.

disclosed the negative return of - 4% on assets at market value. Smoothing was said to have allowed a total return on pensions contracts of 10%. Declared rates were maintained as were total returns. The notes to the statement were in current standard form, but not year-specific:

> "The total fund values include amounts of final bonus which are not guaranteed and may vary up or down. The fund available at retirement may therefore be less than the total value shown, but would not be less than the guaranteed value."

Critically there was still no reference to the treatment of annuity guarantee policyholders who had elected to take the guaranteed rate over the winter of 1993-94. A reader would have been justified in assuming that there had been no material change of policy or practice in the period under review.

115. The layout of the bonus notice was similar to the previous year. The three column format was used, and total values were brought out. There was no indication that the amount of final bonus might alter depending on whether the policyholder claimed the annuity guarantee rights. As in previous years there was reference to what might happen if benefits were taken other than from Equitable. In the bonus declaration for 1992, note 3 to the statement of benefits stated that if benefits were taken other than under the policy, "such as transfer", there was no guarantee whatsoever as to the application of final bonus. That was made rather more explicit in the following year. The Society reserved the right to calculate the fund for transfer differently from the advertised method. There was a similar statement in the current year's notes. There was no reference to any other circumstances in which the method of calculation would or might be different. There was no material change in policyholders' reasonable expectations.

116. At the date of presentation of the 1994 statutory accounts and review in 1995, John Sclater was president of the Society. The published accounts now included a financial review, and the president's statement appeared in that document. The report may properly be described as a celebration of the spotless character and record of the Society. Mutuality, direct sales, a targeted market, and cost control all served to justify the maintenance of the Society's mission. It was said that bonus policy demonstrated the benefit of smoothing out fluctuations in investment returns. Despite a negative return, the Society had maintained declared rates. Mis-selling of pensions business was a topic of general and growing interest at the time. The president commented that even if the Society had a liability for mis-selling compensation, it would be insignificant.

117. The management report was similarly celebratory in tone. Insurance executives from around the world were flocking to the Society's door to see what they could learn. The report reflected hubris in full flower. There were relevant short-term issues. In 1993-4, the Society had had experience of the phenomenon that returned with serious consequences later: the cost of annuity guarantees exceeded the value the Society's current annuities. However, there was no reference to that in the president's report. Sclater refused to be interviewed, and it is impossible to comment on whether or not he knew the position. The financial accounts were now more formal, following revised regulatory requirements. A reasonable policyholder would have been entitled to believe that nothing could cause the foundations of the Society to suffer the slightest after-shock of the second greatest financial earthquake to have struck at the industry as a whole since 1974.

118. In his review in the statutory accounts and review for 1995, Sclater repeated the theme of the excellence of mutuality, and his confidence that the Society would continue to prosper without the need for the injection of shareholder capital. The Society had to secure its future health and success. New products were to be introduced. New means of doing business would exploit technological advances. Foreign business would be developed. Consultancy services would be provided. In relation to bonus policy, he emphasised the essential tenet of mutuality that:

> "each generation of policyholders should be treated fairly and receive a return fully reflecting the investment conditions experienced over the period of the relevant contracts. There should be no deliberate holding back of profits from one generation to the next. This principle is paramount in our consideration of bonuses to be declared in each year."

Members were encouraged to anticipate further growth through the exploitation of the advantages of mutuality. The management report contained in the annual report and financial highlights of 1995, and repeated in substantially the same terms later, contained a statement of the Society's general policy position. The statement reformulated the modern principles the Society claimed to have followed and to be following, but asserted that they were in historical continuity with practice over decades, if not centuries.

119. The with-profits guide dated 1 July 1995 was in broadly the same terms as 1994. Ranson's 'dear policyholder' letter dated March 1996 continued to provide information on bonus policy, and economic trends in the same general format as the previous year. In relation to bonuses it discussed the overall rate of return, and the declared rate, and gave details of the distribution of the various components of total return. The investment roll-up rate was treated as an aspect of total return. In other respects there was nothing remarkable in the positive content of the letter. The conclusion expressed in the letter reflected continuity of purpose. There was nothing to alert policyholders to any significant change of direction of policy affecting the generation or distribution of bonus.

120. The bonus statement for the 1995 declaration followed the previous year's format in respect of the benefits calculations. The notes set out the approach followed in fairly conventional terms. As before, the document was not a model of clarity. Treating the final bonus as a difference continued to suggest confusion between methodology and result. However, there was now a material difference in the information provided in the notes. The critical note was in these terms:

> "(2) The total fund values include amounts of final bonus which are not guaranteed and may vary. In addition, where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee. The fund available at retirement may therefore be less than the total shown, but would not be less than the guaranteed value."

Hyman showed that this assertion was wholly without legal foundation. But at this stage its importance was (a) in its introduction; (b) in the contrast it provided with previous formulations; and (c) in its opacity. It is important to analyse the statement in the light of circumstances known at the time of the letter.

121. As the discussion of the Society's policy forms in chapter 2 has shown, there were some forms that specified terms on which guaranteed annuity benefits could be secured. The Society's group pensions schemes and AVC schemes in particular offered a guaranteed annuity option as an alternative to the primary obligation to provide an annuity on current immediate annuity terms. The retirement annuity contracts such as those discussed in the *Hyman* case did not provide a guarantee of "terms on which annuity benefits can be secured". The language was an inept way of describing the actual provisions of the retirement annuity contracts if they were intended to be within the scope of the note: policyholders had a contractual right to the guaranteed rates in terms of the policy and from its inception. The "cost of providing the guarantee" implied that there was an option that might be taken up, at a cost, as something not already provided in the contract. It must be a question whether any policyholder who read the note would have understood what was being said. Those who knew the terms of their policies would have been entitled to dismiss this as a statement that had no application to them. This was not a clear and unambiguous statement of policy. It was a statement made to policyholders all of whom had previously been informed by Sherlock that they had paid premiums that

were far greater than required to meet the policy guarantees to which they were entitled.

122. There is a further point of note. The differential final bonus was treated as a factor additional to the variability of final bonus rates that was inherent in the practice of allocating such bonuses. It was not presented as an aspect of that policy. However, the policy that was soon to become controversial had now been intimated in a publication to policyholders. The general publications that followed in 1996 did not develop the point. A further edition of the with-profits guide was published on 1 July 1996. In describing the factors influencing bonus rates, smoothing was mentioned. The document set out the distribution of the total allocation in conventional terms. The format was much the same as the previous edition. There was nothing relating to differential final bonuses.

123. In the statutory accounts for 1996, the directors' report described bonus policy as follows:

> "In previous years the Directors have progressively reduced declared bonus rates in order to reflect the downward trend in the rates of interest available on gilt-edged stock. As a result of that strategy, the rates declared for 1993 were consistent with then current interest rates. Since then interest rates have remained at broadly the same level. Accordingly, the rates for 1993 were maintained for 1994 and 1995. The Directors have considered it appropriate to maintain declared bonus rates at the same levels again for 1996."

The increase in total policy values in excess of the build-up of guaranteed benefits was said to be in the form of non-guaranteed final bonus which might be varied at any time before the policy benefits became contractually payable.

124. In the review, Sclater reported increased business, reduced costs, and the advantages of mutuality. On a number of tests of effectiveness, the Society was "strong and ... exceptionally well placed to benefit from the probability that future governments, whatever their colour, will encourage or impose greater private, rather than state, provision." He repeated previous comments about the Society's bonus policy:

> "Throughout our history we have tried to ensure that each generation of with-profits policyholders has received the returns it has deserved on its investments with the Society. Our distributions have been full and fair - i.e. 'equitable'. We have not built up surplus assets in order to boost our 'free assets'. Our 'free asset ratio' is therefore inevitably, and rightly, lower than those of some of our competitors, but this is a reflection of our full distribution policy and not an indication of financial weakness."

Sclater encouraged the view that the Society's policy was sound and well-balanced. In relation to management, he continued his predecessor's practice of expressing objection to PIA fees. The Society should pay less because it took less effort to regulate it:

> "Virtue should be rewarded, not punished. We hope that our policyholders will support this stance."

Policyholders would have been encouraged to believe that there could be no stain on the Society's regulatory record, nor any threat of a stain being discovered. Provision for compensation payable relative to past transfers and opt-outs was relatively modest: I was said that there would be no material impact on the Society. Few, if any, policyholders would have entertained any doubt about the Society's continued health. Nor would the statement have drawn attention to the differential final bonus policy.

125. Ranson's 'dear policyholder' letter and the bonus notices on the 1996 declaration followed the previous pattern in giving background information. The letter described the approach of determining an appropriate smoothed overall rate of return for the calendar year, taking into account the actual investment experience of

the current and recent past years. That smoothed return was distributed in the customary three ways. The observations on final bonus were as before. In relation to future expectations, the letter forecast reducing returns. Smoothing was relied on to retain some of 1996's high levels of capital appreciation. The letter also stated:

> "The 1990s have been a period of unusually volatile investment returns with two years of negative earnings and one year of exceptionally high returns. Beneath that volatility the basic feature seems to be a growing acceptance that the U.K. is experiencing, and will continue to experience, a sustained period of inflation at a much lower level than was normal in the two preceding decades. As that acceptance develops, expectations will adjust to the new low inflation environment. A general trend towards lower average returns, affecting all types of savings, can now be seen, although overlaid with the effects of short-term changes in investor sentiment, particularly in the case of equity investments."

Policyholders' expectations were again being reduced in the context of projections of the Society's likely trend of earnings in the economic climate anticipated. The conclusion repeated earlier statements:

> "The results which any life office can pass on to its with-profits policyholders are largely determined by the underlying investment conditions during the lifetime of each policy.."

126. The benefits statement forms followed previous year's pattern of calculation, presenting total policy values under now conventional heads. The notes referred to the differential final bonus policy in slightly altered form. So far as material, note 1 now provided:

> "The non-guaranteed final bonus addition is the difference between the total value and the guaranteed value."

The second note to the statement of benefits was in the terms used in the previous year and quoted in paragraph 120 above. This letter repeated the assertion of the directors' right to charge for what it had already intimated that it might pay subject to financial conditions. In other forms issued in 1997 for the 1996 declaration analysing with-profits transactions during the year, similar expressions appeared.

127. In 1996 and 1997, the Society was sliding inexorably into conflict with annuity guarantee policyholders. In respect of policyholders' reasonable expectations in relation to bonus, there had been some developments. In relation to the determination of surplus available for allocation as bonus there was little change, except that policyholders might have come to understand that the Society viewed guaranteed interest as a component of the total return of the same character as declared bonus. The policyholder would have expected that declared bonuses were a fixed liability that must be paid whatever the level of financial markets at the date of payment. The policyholder would have understood the policy of benchmarking to the redemption yield on fixed interest securities with an associated 'obligation' to make up the shortfall in yield to existing policyholders. It would have been understood that the Board's view was that declared bonuses were, but that future bonuses and in particular terminal bonus were not guaranteed.

128. A range of factors would have contributed to policyholders' reasonable expectations relating to final bonus at this period. It would have been understood that, generally, the variability of the terminal bonus was related to prevailing financial conditions, and that the amount of final bonus would depend on the future experience of the Society and have the character of a final balancing item in the overall return. The crucial issue is whether the 1995 changes in the notes appended to the bonus notices altered reasonable expectations. Until 1995, policyholders would not have expected that the exercise of a contractual right could be a factor in the determination of final bonus. In 1995, the differential terminal bonus policy was intimated to policyholders. Since this was held to be a breach of contract its impact on policyholders' expectations has been nullified. But there is a question whether

the intimation would have altered reasonable expectations in respect of the future benefits that might be obtained from new contributions.

129. In relation to total policy proceeds, factors contributing to policyholders' reasonable expectations at this stage had not changed except in respect of terminal bonus. There is an issue whether the Equitable Board was entitled to alter policyholders' reasonable expectations retrospectively. Accrued rights referable to and based on established expectations were vulnerable to changes in market conditions, and were consistently said to be liable to variation at maturity if the Society's experience proved to be adverse at that time. A discretion retrospectively to remove previously intimated prospective benefits on a change in advertised policy is materially different in kind. Whatever the subjective understanding of a typical policyholder, a material change in policy undermining established reasonable expectations would have been an obvious trigger for regulatory intervention. In my view, changes in reasonable expectations relating to accrued benefits cannot be made instantaneously. On the other hand, an additional contribution made after intimation of a change of policy perhaps cannot be made on the basis of expectations that ignore the new policy.

130. The issue can be considered with reference to a policyholder who had contributed regularly to a pre-1988 retirement annuity contract and received annual literature informing of the risk that terminal or final bonus could be vulnerable to changes in economic conditions at the date of maturity. That risk would necessarily have been acknowledged, but moderated by the Society's established practice of countering adverse market movements by smoothing, a practice that could have been assessed by reference to what was done in 1990 and 1994. The statements in the notes and publications down to 1995 were statements of current practice. Any policyholder who is treated as having an insight into the 1995 and 1996 notes must be assumed to have made contributions until that time in the full understanding of the earlier advertised policies. Whatever the meaning and intent of the test of policyholders' reasonable expectations, it must be prospective. The adoption of the differential final bonus policy affecting accrued benefits down to 1995 could not be justified in terms of policyholders' reasonable expectations developed in the light of communications at the time contributions were made. But for the decision in *Hyman*, however, a person who made additional contributions on a retirement annuity contract in 1996-7 or 1997-8 would have had intimation of the new notes, and might have been held to have his reasonable expectations affected by them in relation to any additional contributions made, given the character of the recurrent single premium contract. I, this case, I incline to the view that this would be to put too much emphasis on a 'small print' note when there were major publications describing the Society's policies and practices that made no reference to the new policy. There is, however, a general issue: is it possible for a life office make a step-change in policyholders' reasonable expectations and, if so, how is that achieved? At very least one would expect clarity and openness of intimation, a period of warning that the change was coming into effect, not least to allow policyholders to take advice and perhaps decide whether to take their business elsewhere, and consistency in explanation in documents intended to describe the office's business. Equitable's approach could not be justified on such views.

131. But matters were to get worse: in relation to 1997, the policy was not intimated at all. The with-profits guide dated 1 July 1997 was in similar terms to the previous year's edition. There was no reference to the differential final bonus.

132. The directors' report in the 1997 statutory accounts gave a mixed message on rates. The president's statement in the review presented the year as one of success in achieving further milestones in total premium income. Investment performance had been generally good in difficult conditions. Overall the rate of return on the with-profits fund was 17.2%. The Board therefore had decided to increase the total rate of return for 1997, reducing declared rates to reflect the lower returns expected in the future if low rates of inflation were maintained. The advantages of mutuality were re-stated. The deliberate policy of avoiding the build-up of unnecessary free

reserves, an 'orphan' estate, was given emphasis. The president reported the issue of £350m of subordinated guaranteed bonds through a special purpose subsidiary. The success of the issue was said to demonstrate the high regard in which the Society was held. The transaction was portrayed as an ordinary tool of management. He did not explain why the Society would want external funds for investment at this time, and in an amount that was a relatively small proportion of the annual premium income of the Society. It ran counter to his previous statement that the Society did not need external capital because of the strength of mutuality; and it ignored the reality of the Society's narrowing solvency margins that probably was the sole substantial explanation of the transaction. But, in terms of policyholders' reasonable expectations, it would have strengthened confidence in the financial strength of the Society and in the prospects of sustained good performance into the future. The president repeated his complaint that the Society's success meant that it was paying too much for regulation. Mis-selling compensation was again dismissed as immaterial. The management report continued the practice of celebrating the Society's success. There was no reference to the differential final bonus.

133. The bonus notices and explanatory materials were changed for the 1997 declaration. The letter to policyholders was dispensed with. The material formerly provided in that letter was presented as background information appended to the statement of benefits. The notes recognised the volatility of investment conditions, the anticipation of low inflation and low long-term interest rates, and declared a total return, which was said to reflect the realities of the economic situation. The financial summaries followed previous models. The notes were in the following terms:

> "1. The guaranteed value as at 31 December 1997 is calculated by applying the rate guaranteed in the policy and the declared bonus rate to the guaranteed fund value as at 31 December 1996, and then adding in the benefits purchased by contributions paid during the year accumulated at the equivalent rates for the periods of investment. The guaranteed value is also adjusted to allow for any payments/switches out as they occur during the year.
>
> 2. The non-guaranteed final bonus addition is the difference between the total value and the guaranteed value. The amount of final bonus payable is not guaranteed and may vary. The actual amount payable will be determined when benefits are taken.
>
> 3. The total value as at 31 December 1997 is calculated by applying the overall rate of return for the year to the fund value as at 31 December 1996, and then adding in the benefits purchased by contributions paid during the year accumulated at the equivalent rate for the periods of investment. The total value is also adjusted to allow for any payments/switches out as they occur during the year.
>
> 4. On retirement on or after 1 April 1998 but before 1 April 1999, the benefits will be calculated by accumulating the value as at 31 December 1997 and the benefits purchased by any further contributions at the interim overall rate of return in force at the time. The value is also adjusted to allow for any payments/switches out as they occur.
>
> 5. On retirement the amount payable is the guaranteed value plus the non-guaranteed final bonus addition, if any, available at the time. The total value represents an illustration of the amount payable on the dates shown. The amount payable in other circumstances (for example, as a transfer to another pension arrangement or a switch to unit-linked investment) is not guaranteed and may be less than the guaranteed value."

134. It has been stated that the omission of reference to the differential final bonus policy was a simple mistake. I have no contrary evidence. However, what is material is the message communicated to policyholders. Viewed in isolation, this statement

would have indicated that whatever the obscure communications of the previous two years had indicated, the society had departed from the point.

135. However, it is necessary to have regard to other materials in use at the time to have a full picture. The Society continued to provide statements of value on request. One such statement dated 1 April 1998 included final bonus. The notes stated inter alia:

> "(2) The total fund value includes an amount in respect of final bonus which is not guaranteed and may vary up or down. The value shown should not therefore be regarded as the minimum possible value of the policy. In circumstances other than those covered by the policy conditions, for example transfer to another pension provider, the Society reserves the right to calculate the fund in a different way."

Later in 1998, the policyholder in question sought an illustration of the annuity available on the guaranteed basis. The quotation, at 5 November 1998, referred the policyholder to the leaflet 'Taking retirement benefits from Equitable Personal Pension Plans and Retirement Policies', and informed him of the level of guaranteed annuity assuming a guaranteed fund value of a value intermediate between the total fund value and the guaranteed benefits disclosed in the earlier statement. The differential final bonus policy had been applied, but not explained. Another policyholder, whose husband had elected to take a managed pension, and who had previously been provided with inaccurate information in respect of her own policy, received more explicit information on the operation of the differential final bonus policy. The message for the policyholder in question was presented with clarity: if she exercised her contractual rights, final bonus would be restricted to ensure that she did not get a higher annuity than would have been available on a different contract form. It was to be the beginning of dispute in those cases. The Society was to find that targeting a high quality market had disadvantages in a dispute.

136. By the end of 1998 the Society was caught up in disputes with its annuity guarantee policyholders on a wide range of general and particular issues. The Society set out a defence of its practice in relation to pre-1988 pension policies in a leaflet: 'With-profits policies containing guaranteed annuity rates'. The Society's position was summarised:

> "The following points summarise the operation of the annuity guarantees where the client chooses the form of annuity guaranteed in the policy.
>
> a. The guarantee provides a minimum value below which the level of retirement income will not be permitted to fall.
>
> b. The annuity guarantee within the policies is applied in all cases where the policyholder will benefit.
>
> c. The value of the policies at retirement, as shown on annual statements, will reflect the full smoothed value of assets attributable to the policies. On choosing the form of annuity guaranteed in the policy the value of the benefits will be at least as high as the asset value and, in some cases, will be of greater value.
>
> d. The operation of the annuity guarantees is in accordance with the terms of the contract and the bonus policy set by the Board."

137. The full text set out these propositions at greater length but with no greater clarity. It was stated that:

> "These policies are written in somewhat different ways but, irrespective of the way in which they were written, they all essentially provide policyholders with the choice of taking the fund value to purchase an annuity on current rates (the open market option), or taking a guaranteed annuity alternative. Thus such policies have both a guaranteed cash sum at retirement and a guaranteed annuity alternative."

That was accurate in the case of some classes of contract. It was not accurate in the case of retirement annuity policies.

138. The mechanism used to arrive at the result the Society sought was said to involve an application of asset share methodology. The leaflet stated:

> "Returns on invested contributions are averaged out to determine a policy's accumulated 'asset share' and are passed on to policyholders as a mixture of guarantees, annual declared bonuses and non-guaranteed final bonus depending on the type of policy held. Consequently, as each policy approaches maturity the amount of bonus still to be given, if any, will depend on how much of the 'asset share' has already been allocated by way of guarantees or annual bonus additions.
>
> Generally, a final bonus is payable to lift the guaranteed benefits and declared bonuses to the appropriate 'asset share', but there will be circumstances where the 'asset share' has already been given or exceeded through the addition of annual declared bonuses or the operation of guarantees. In those circumstances no final bonus would be payable and there would be no question of reducing policy values to the lower 'asset share'."

139. Since this was addressed to policyholders who had consistently over the years been sent statements incorporating accrued final bonus, some further explanation was required:

> "For the past 10 years or so the Society has followed the general industry-wide practice of illustrating policy benefits in the form of a cash fund available to purchase an annuity.
>
> That cash fund can be used to purchase an income at the Society's current rates or in the open market. The alternative option of taking benefits in the annuity form specified in the policy was not illustrated.
>
> As interest rates have declined, this has reduced current annuity rates to the point where the annuity form of benefits in certain policies becomes attractive as an alternative to the cash fund option. If the annuity option is selected the Society compares the value of the minimum income already guaranteed under that option with the 'asset share' it is aiming to pass on to the policyholder to determine the level of any 'topping up' needed by way of final bonus. As previously indicated, the calculation may reveal that the minimum income guaranteed under that option is already worth more than the 'asset share' in which case no final bonus annuity is payable."

140. There is no reason to believe that the statement was other than an honest expression of the beliefs of those who wrote it. Its meaning was no doubt clear to them. But it had the quality of a challenge that was unlikely to avoid a rejoinder. It asserted the rightness of the Society's position without acknowledging any scope for different views. It misrepresented the contract form and the terms of many of the policies affected, and invited close scrutiny of all forms of policy. The only reasonable expectation following on this document was litigation in some form or other. Leaving that aside, the content of the statement came close to the explanation of the Board's policy that could properly have been expected to be published when the policy was formulated. Had it been published in 1983, when the policy was first resolved on, or in 1993 when it was first applied, policyholders' investment decisions would have been informed. A policyholder who continued to make additional contributions after intimation of such a policy would have known the basis on which he was making the investment decision. But there was no statement that was remotely equivalent in earlier publications or communications.

141. The directors' report in the statutory accounts for 1998 was, in the circumstances, a singularly anodyne document. On page 28 of the accounts, in note 17, paragraph (vi) it was stated:

> "An additional amount of £200m is included as a prudent provision for any additional liabilities which may arise through clients choosing to exercise guaranteed annuity options under their policies."

The description of the sum as an 'additional' amount, without explanation of what it was added to made the statement particularly obscure. In the review, the president's statement commenced:

> "1998 was an unusual year for The Equitable. Over the last few months of the year we received unfavourable publicity over guaranteed annuity rates and I comment on that topic below. The Equitable has generally enjoyed favourable press comment and to be the subject of criticism has caused many of our members, your Board and our staff great concern - particularly as the Society's approach stems from its principle of treating all of its members in a scrupulously fair and correct way."

His other comments were intended to take the edge off the adverse publicity. Bonus policy continued to follow the same guidelines. Guaranteed benefits were reduced in view of the likely continuing fall in yields. The president reported that the declaratory litigation had begun. In the circumstances he said that he could not debate the merits of the case. But he expressed the directors' concern to ensure fairness between all policyholders and to ensure that each policyholder received a fair share of the Society's assets when the time came for payment.

142. Had the litigation been postponed, Sclater could have been more open. But as events had happened, the members did not have a report on the annuity guarantee problem that was not coloured by current litigation. Sclater reported that the directors' estimated the maximum cost of the annuity guarantees at £50m, but that the Board was said to have provided £200m as a prudent step having regard to the uncertainties relating to future changes in financial conditions and mortality experience. He reported on the liability for mis-selling compensation. The Society had paid £47m for phase I; and there was an estimated liability of £59m for phase II. The sums were not treated as material to an assessment of effectiveness of management.

143. In the Society's other publications matters were reported in the usual fashion. In 'Bonuses for 1997', the general description of the Society's approach was similar to the 1996 with-profits guide. The 1997 declaration was discussed in terms of investment strategy and returns. It was noted that the guaranteed rate of bonus had been reduced. The system was explained in terms similar to those used in earlier publications. The date of publication may have been early in 1998: it was not dated. But an early date might explain why it did not reflect the annuity guarantee debate.

144. The with-profits guide dated 31 August 1998 was altered materially. It came late: 31 August was two full months later in the year than the latest previous publication. There was some new material on bonuses reflecting changed contract forms that excluded growth in guarantees and made policy proceeds depended wholly on final bonus. In relation to bonus policy the guide stated:

> "Policies of the 'recurrent single premium' type, which are the large majority of the Society's business, guarantee a minimum rate of build-up of benefits in the basic policy terms. For modern contracts that minimum rate is zero. Except for some special types of contract, where all additions are granted as final bonus, the excess of the rate of growth of guaranteed benefits for the year over the minimum guaranteed in the policy is granted as declared bonus for the year. The difference between the total policy value at the end of the year and the value of the guaranteed benefits (built up as described above) is the final bonus element in the total policy value. Final bonus is payable when a contractual policy event (such as retirement) occurs."

145. Chapter F described the Society's general approach in usual terms. The guide set out historical data. It then gave an example that showed how guaranteed rates and non-guaranteed rates operated in the case of a personal pension contract for

1997. Actual growth rates over the period 1989 to 1997 were tabulated with notes. The document also explained the market value adjustment. There was a somewhat enigmatic note:

> "Although minor refinements to the bonus approach have been made over the years and special rules apply in some circumstances, such as where particular benefit guarantees apply, it is not seen as likely that it would be necessary to make fundamental changes to the approach..."

Having regard to its date, the preparation of this guide may not have reflected fully the dispute with annuity guarantee policyholders. However, the first complaints by annuity guarantee policyholders to the PIA Ombudsman were made in July 1998, and by the date of issue the Society must have been aware that its policy stance was disputed. It must have anticipated the possibility of trouble from the decision already made that there would be a differential bonus policy. The inexplicit reference to "special rules" would have been distinctly misleading if intended to refer to the discretionary power asserted to enable the directors to adjust final bonus payments. But by this stage few policyholders would have been anticipating the future with any certainty.

146. The benefits statements for 1998 and the relative explanatory notes were amended from the earlier forms. The notes to the bonus notice issues to annuity guarantee policyholders stated:

> "This policy contains guaranteed rates of annuity which apply to with-profits benefits secured by contributions paid. At retirement, such benefits under the policy may be taken in guaranteed annuity form, or the total value of the benefits available, if taken in fund form, may be used to purchase an annuity from the Society on current rates or may be taken under the open market option to purchase an annuity from another provider.
>
> The value of benefits in guaranteed form will never be less than the total value of the with-profits fund available at retirement and, depending upon financial conditions, may exceed that total value. That is because the annuity payable will be at least as high as that produced by applying the Society's current annuity rates to the total value. ...
>
> The non-guaranteed final bonus is the sum which the Society would need to allocate to the policy by way of addition to the guaranteed value to produce the total value of the benefits available if taken in fund form and used to purchase an annuity on current rates. The actual amount of any final bonus will be the sum which the Society would need to add to the guaranteed value at retirement in the financial conditions prevailing at that time in order to produce the then actual total value. If the policyholder takes benefits in guaranteed annuity form, and if guaranteed annuity rates are higher than current annuity rates, the amount which would be needed to be added by way of non-guaranteed final bonus in order to bring the value of the benefits under the policy up to the stated total value will be less than that required if current rates were applied, and could be nil.
>
> The actual amount of any final bonus is entirely a matter for the Board of the Society in the exercise of its discretion and it not guaranteed under the policy..."

147. Legal advice had been taken from the solicitors and from Brian Green QC. However, the obscurity of the Society's position had deepened. At first blush the statement would have required to be challenged by the informed policyholder, quite apart from *Hyman*. On previous statements, the non-guaranteed final bonus was arguably an aspect of the total returns on investment over the life of the policy, kept back from declaration as reversionary bonus to enable the Society to pursue a balanced investment strategy. The notion that the non-guaranteed or "unconsolidated" part of the fund was a function of a current annuity rate determined at maturity on some unspecified basis is not obviously correct. In terms

of the policyholder's assessment of reasonable expectations, given the Society's commitment to openness of communication, this statement was unlikely to contribute anything other than confusion.

148. The statement proceeded:

> "The actual amount of any final bonus will be the sum which the Society would need to add to the guaranteed value at retirement in the financial conditions prevailing at that time in order to produce the then actual total value."

This appears to have been predicated on the validity of the first sentence. But it is questionable whether it amounted to any more than a statement that if a non-annuity guarantee policyholder would have got an annuity of £x on a given final fund, the annuity guarantee policyholder would get no more than £x and his terminal bonus would be altered to secure that result. The final sentence effectively stated that position:

> "If the policyholder takes benefits in guaranteed annuity form, and if the guaranteed annuity rates are higher than current annuity rates, the amount which would be needed to be added by way of non-guaranteed final bonus in order to bring the value of the benefits under the policy up to the stated total value will be less than that required if current annuity rates were applied, and could be nil."

The sentence again assumed an objectively determined "stated total value", which might have been open to challenge irrespective of the *Hyman* decision. It appears that a zero final bonus would have applied equally where the result was more than or equal to the current annuity level because the guaranteed fund could not be reduced. The paragraph as a whole ended with the ultimate statement of the Board's position that:

> "The actual amount of any final bonus is entirely a matter for the Board of the Society in the exercise of its discretion and is not guaranteed under the policy."

149. This extended exposition of the Board's position could have been material for the future had the outcome of the *Hyman* litigation been other than it was. In the event, its importance is in the length and complexity of the argument required to inform policyholders of the Board's position. In the light of this exposition it appears beyond argument that at no earlier stage had the policyholders of the Society received information that would have exposed the Board's position and informed the reasonable expectations of policyholders or potential policyholders.

150. The statutory accounts and review for 1999, including the Directors' report, were again rather characterless. There was a somewhat defensive 'Guide for clients' on the accounts and accounting principles applied. In the review, the president described 1999 as a "challenging year", but again one of considerable achievement. The Society had achieved relatively high returns on investments; there had been a disciplined approach to bonus declaration; and rates were maintained. The message was that there were difficulties, but generally it was business as usual for the Society. The bonus material repeated the Board's position of the previous year.

151. In the 2000 annual report and accounts, the management report dealt with the Hyman case. The Society had lost. The additional cost was estimated at £1.5bn. For most classes of business no bonuses would be allotted for the first seven months of 2000. It was reported that:

> "The growth in policy values held back matched closely the estimated additional costs of the GAR liabilities."

The result of the case diminished the Society's capital strength, and reduced its investment freedom. It was reported that a decision had been taken to put the Society up for sale as a whole. That process failed on 7 December 2000. The Halifax

contract was negotiated and concluded. The report proceeded to justify the Board's conduct of business. "A financial adjustment" had been introduced on 20 July 2000. It was stated that the purpose of the financial adjustment was often misunderstood. It was to ensure fairness. Similarly members were told that a rectification scheme had been developed for those whose policies had matured between 1 January 1994 and 12 July 2000 and who might have suffered from the differential final bonus policy.

152. The only material change in policyholders' reasonable expectations that might have been derived from this statement was in relation to the impact of the *Hyman* decision. The position was said to have been balanced by withholding seven months' growth in policy values. The statement continued with a statement of justification of management's approach. It would not have been unreasonable for a policyholder reading the accounts and related information to conclude that the steps taken by management had dealt effectively with the adverse implications of the House of Lords' decision. Note 18(v) set out details of the provisions made for GAR and associated liabilities, and for mis-selling, in sums significantly greater than previously. The auditors' report was qualified for the first time.

153. Meantime, the Society continued to solicit renewal business. The terms in which it did so are illuminating. In a renewal reminder to a policyholder dated 12 February 1999, the policyholder was encouraged to make further provision for his retirement. The policy value was said to be £69,540.50. The note qualifying the reliability of the policy value referred to "the terms and conditions *detailed* in your policy and annual statement". In other respects, the Society's renewal request form was bland and uninformative about the annuity guarantee risk at that stage. The approach was consistent with a view that the Society's position, even at that late stage, could not have been wrong.

Terminal bonus provisions

154. Policyholders would not have expected the Society to make provision in its technical provisions or mathematical reserves for terminal bonus at any material time. The Society was not in a position to make any provision for terminal bonuses until the end of the triennium 1976 to 1979. In February 1980, in the valuation report for 1979, the actuary recommended a provision:

> "If the assets are written up as recommended, the fund shown in the balance sheet will be £431m as against a total liability of £425m. This will leave a margin of about £6m, which will enable us to make specific advance provision for terminal bonus payments during the next three years, a provision it has not been possible to make before."

155. However, that was not communicated to members. The Society's practice at 31 December 1979 was not followed at any subsequent valuation: terminal, and later final, bonus was not provided for in liabilities. Policyholders were informed that that was the Society's practice. But at least into the 1990s[11], the overall impression communicated to policyholders was that there would be a terminal bonus, related to the investment reserve, to allocate a final share of profits to outgoing members. Until the mid-1990s final bonus was explicitly subject to the risk that investment conditions might change and affect the availability or rate available at maturity. Recognition of final bonus in holding appropriate sums on investment reserve would have reflected best industry practice, but that practice was not applied by the Society after 1986. In the later 1980s and in the 1990s in particular, the trend was towards higher allocations, and the gradual reduction in retained funds. By 1987, all inherited surpluses had been allocated and the full distribution policy was in place. The aggregate of contractual benefits and accrued final bonus exceeded the assets at market value.

[11] See paragraph 85 above.

156. By the early 1990s, the representations to policyholders included the representation that benefits built up continuously, that what mattered was the overall rate of return, and that the reserved power to alter rates related to financial conditions at maturity. Consistency in production of fair results was the aim of management. That was said in an economic climate in which the Society had in some years suffered heavy losses on investment, and still allocated high returns. It would have been irrational for any policyholder to form the view that terminal bonus would disappear from the statement of policy values instantly in the foreseeable future. Had anyone formed that view, it is unlikely that he or she would have remained with the Society as an investor.

157. In the mid 1990s, the proportion of the total allocation that remained unconsolidated continued to increase. There were warnings that ultimate proceeds might be less than the total value intimated to policyholders in annual statements. The Society continued to allocate sums that substantially increased total policy values, but with relatively smaller increases in the consolidated benefits. In July 2001 this facilitated the reduction in policy values. With the exception of investments made over the five preceding years or so, the cuts were applied against accrued terminal bonus. In chapter 6 I have expressed the view that some such drastic adjustment was inevitable at some stage in the light of the policies that had been pursued. There is no evidence to support an allegation that the practice of management was a cynical exercise creating a superficial picture of growing value while cloaking an intention to undermine the expectation that total policy proceeds would be available at maturity. The specific intentions of the Board relating to the differential terminal bonus apart, payment of terminal bonus was a well-established expectation.

158. More particularly, there was the Society's consistent practice of allowing claims to crystallise at full value as shown by the office valuation, notwithstanding the over-allocation of bonus, and final bonus in particular. There is no doubt that at least some of the Society's senior management were fully aware of the pattern of over-distribution. Headdon's August 1997 memorandum to Nash contained much of the basic material reflected in the earlier years of the analysis prepared for Nowell in 2001. The position in the first few years was also reported by Ranson to GAD during discussions of the Society's returns[12]. Headdon's comments indicated that the exercise was carried out after every valuation, though records of that have not been recovered. There was sustained over-allocation of total bonus, and within that, for significant periods, over distribution of reversionary bonus, and over-payment on maturities.

159. There are problems related to the expectations the members might have formed of their directors' conduct. It is impossible to form a confident view of the extent of the knowledge and understanding of individual directors, or of the non-executive members of the Board as a whole, on this matter. Those directors who were prepared to speak to the inquiry denied knowledge of significant and sustained over-allocation of bonus. But they could only speak for themselves. Their lack of knowledge could not exclude the possibility that others were aware of the facts. Individually the witnesses may have been absent when the information was given, or they may have failed to understand the implications of the actuarial advice. As in many aspects of direction of the Society, one is left in doubt as to the extent of the Board's understanding of the technical aspects of the business. To the extent that there was over-allocation, one is not concerned with technical issues: there simply was excess allocation relative to the Society's available resources.

Surrenders and transfers

160. A significant contributory factor in over-distribution was the Society's practice of paying full policy value, subject to a market value adjustment from time to time,

[12] See chapter 16, paragraph 77.

on surrenders and transfers. The market value adjustment, when applied, affected values marginally, reducing the total policy value to, or in the direction of, the equivalent of asset share on the Society's approach, but the underlying problem was allowing policy value as the reference value in the first place. In due course, the Society's solicitors and counsel took the view that the practice was not a proper reflection of the Society's contractual obligation. That view was not dealt with in the *Hyman* case.

161. But the Society did not seek legal advice on its practice until, in the course of contingency planning relating to the *Hyman* litigation[13], it had to confront the risk of total failure in the litigation and an anticipated mass-exodus of non-GAR policyholders from the with-profits fund. The material contingency was that the ruling would be that the Society's approach was invalid and that final bonus rates on cash and annuity benefits must be equal in relation to all relevant with-profits policies, whether with or without GAR provisions in them.

162. This brought to the notice of the legal advisers the Society's practice in dealing with transfers generally. In the course of consultation on 20 July 1999, counsel were told that in practice the Society had included notional final bonus in calculating surrender values in the past. The Society's position as presented to its legal advisers was that the value of a policy was set out in the annual statement. This value represented a share of the assets of the Society. Annual statements came with guidance notes that stated that the value quoted was not guaranteed. Leading Counsel advised that the annual statements quoted the policy's value at selected pension age, and that until then there was no right to benefits at that level.

163. The Society was advised, in respect of the risk of mass 'surrenders' or transfers, that the retirement annuity contract forms did not entitle the policyholder to transfer, and that, unless the Society had stated otherwise so as to create PRE, the Society had control of timing, and of transfer value. There was no contractual basis for fixing transfer value in those cases accordingly. Thereafter, Equitable explored means of stemming an anticipated flow of withdrawals by non-GAR policyholders. Market value adjustments (MVAs) were discussed. The Society's view was that whether or not to apply such an adjustment depended on whether the policyholder was making a financial decision or responding to changed personal circumstances. The calculation of surrender values was discussed at length. But until then the internal view was that stated in the last paragraph.

164. The Society's executives sought advice on whether the starting point for calculating a surrender value was the guaranteed value of benefits under the policy or the total of the premiums paid under the policy. Leading counsel concluded that the value of the benefits guaranteed under a policy should form the basis of the calculation of the surrender value. It was then necessary to ascertain what further legal obligations applied to the calculation. Common law principles applied to the exercise of a contractual discretion. Under these principles the discretion had to be exercised "fairly, reasonably and bona fide". Leading counsel said that there was a suggestion that there might be a fiduciary duty but that it appeared that the courts had been reluctant to import this concept into contract law.

165. Leading counsel explored the criteria used to justify applying discount to the guaranteed value of a policy. Counsel's advice was that, with the exception of retirement annuity policies (RAPs), the Society was bound to accede to requests by policyholders who wished to transfer their benefits. Where there was a provision for a transfer value in the rules, the surrender value of the policy had to equal the amount the scheme was required to provide as a transfer value. Counsel felt that in the case of personal pension schemes there was no power to discount the surrender value below the guaranteed value of the benefits under policy or the bid value of the units held under the policy. However, in relation to occupational pension schemes, the regulations did permit a discount below these levels although any discount

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[13] See chapter 1.

should be exercised rationally. On counsel's approach, where there was a right to demand transfer, and the transfer value was not specified in the contract documents, guaranteed benefits provided the starting point.

166. This advice was inconsistent with the Society's practice up to that point. The Society had not explored its legal obligations in this respect. Leading counsel said that since there was no strict legal obligation to pay total fund values on surrender, there was no difficulty with a change in practice to basing transfer values on guaranteed benefits. Where, as in the case of RAPs there was no contractual right to transfer, the Society was free to adopt the same approach.

167. In relation to the Society's forms, leading counsel said that the policy literature, although making clear that the Society reserved its rights, contained a number of statements to the effect that policyholders could expect to receive the value of their guaranteed benefits on surrender. He referred to the covering letter to policyholders and bonus notice dated 1987 that stated that "the full value of the policy may not be paid out if it was required to withdraw the benefits in circumstances not covered by the contract terms". This statement suggested that there was a possibility that the full value of the policy may be paid out in certain circumstances. In some respects the advice reflected a confusion of language that ran through much of the discussion. The documentary evidence referred to 'full policy value', not the value of guaranteed benefits. But for present purposes the validity of the advice is not a material factor: what matters is that the scope of the discussion and the advice tendered is a reflection of the extent to which the Society had prior to this time proceeded without advice, exposing the documents issued to interpretation without reference to legal technicalities.

168. The ground was covered again on 11 November 1999 at a further conference, albeit with different counsel[14], following the *Hyman* decision at first instance. Counsel advised that the Society had a measure of discretion as to the exact amount of the transfer value. He commented that in the *Hyman* case the Vice-Chancellor appeared to be saying that policyholders had legitimate expectations, above and beyond their contractual rights, that the life office concerned would act reasonably and with consistency according to its own past practice and general past practice in the industry. Reasonableness and consistency were therefore two key watch words to be drawn from the Vice-Chancellor's judgment. If the life office acted reasonably, fairly and consistently, the court would not interfere with the exercise of the directors' discretion. Counsel again advised that the legislation and the terms of the policies indicated both that, where there was a right to transfer, a substantial value must be paid on transfer and that there must be a strong correlation between the transfer value and the value of the fund at the date of transfer. Further, it was clear from the *Hyman* decision that the Society could not act arbitrarily in any circumstances. The question was therefore what factors should be taken into account by the directors in formulating policy as to transfer values, in the special circumstances where transfer requests began to flood the Society.

169. Counsel again queried the use of MVAs made by the Society to with-profits policies on transfer in the past. Chris Matthews of the society's actuarial department explained that the use of an MVA was designed to bring about the smoothing of the return from the un-smoothed return that would normally apply at the time of transfer. Counsel further reiterated his previously expressed view that the guaranteed value under the policy only applied at retirement and not on early transfer at all events. Matthews explained again the Society's philosophy that they did not seek to profit from an early surrender unless they suspect that the policyholder was "selecting against" the office.

170. Counsel said that it was important to consider the Society's past practice on surrender. He made use of past practice in relation to unit linked policies by way of example. He advised that the Vice Chancellor's judgment made clear that, amongst

[14] Paul Newman.

the factors that the Society could take into consideration, it was entitled to take into account a change of circumstances. Thus, in the *Hyman* case the Society was able to take into account the marked fall in annuity rates in the early 1990s. He said that provided that the Society's approach was made clear to policyholders as early as possible, the Society would be entitled to take account of a flood of transfer requests in setting transfer values. He concluded that in the Society's case, the directors could justifiably maintain that the decision to discount transfer values was taken, at least in part, in order to safeguard the Society's future.

171. Headdon continued with previous practice. The issue of transfer values arose again on 3 July 2000 in discussions with the Society's legal advisers:

> "40. CPH [Headdon] confirmed that the Society had continued its existing practice of calculating transfer payments by reference to total value rather than the guaranteed fund only. BG said that this was contrary to the legal advice to the Society about a year ago, which was to the effect that the Society should only pay what it was legally obliged to pay by way of transfer sums.
>
> 41. CPH said that whilst he understood this and had sympathy with it where a policyholder was simply taking a short-term profit and choosing to put his money with a different pension fund provider. Transfers sometimes took place in different circumstances, particularly where an employee changed jobs. In that situation he thought it right for the policyholder to see the benefit of the non-guaranteed element of "total value".
>
> 42. CPH said that transfer applications had continued at a low level.
>
> 43. CIML [Cindy Leslie, the solicitor from Dentons] repeated her previous advice that the directors of the Society will be criticised if they continued their very generous past practice and made transfer payments in excess of legal entitlements. The application of the preservation legislation meant that the Society's current approach was generous. This was also the case in relation to RAPs where there was no entitlement to any transfer and the preservation legislation did not apply.
>
> 44. CPH thought that if there was an adverse judgment he would stop giving credit for the non-guaranteed elements. CIML asked if this matter would be referred to the Board since there would be a significant change in practice. CPH said that he would consider doing so, but in the past the Appointed Actuary had dealt with transfer payments and he did not want to set a precedent by going to the Board."

It is therefore clear that as late as the summer of 2000 the Society continued to credit policyholders on transfer with full policy value, subject to any appropriate market value adjustment, after legal advice had been received that the Society's obligation was restricted to paying on the basis of guaranteed benefits. This practice had continued over many years.

172. On 19 July 2000, a summary of the position, written immediately before the House of Lords' decision, was set out in a letter by Dentons to Headdon. First Leslie set out her understanding of the established practice:

> "My understanding is that, in the past, the Society's normal practice has been to make transfer, surrender and internal switch payments at the levels set out in the most recent annual statements. On this basis, the values have reflected guaranteed and non-guaranteed elements of policy value. In effect, the Society has not sought to "profit" from early surrender or transfer unless it suspected that the policyholder was selecting against the office. Market value adjustments have from time to time been used to smooth the return on transfers, internal switches and surrenders.
>
> This system has operated for many years and in circumstances where the Society has never had a flood of surrenders and transfers. Whilst in that context my understanding is that as the Appointed Actuary you have thought

> that the policy is appropriate, you have been thinking about a change in practice if the Society is confronted by a flood of transfers and surrenders, or at least a risk of this happening, following a scenario 6 judgment from the House of Lords."

Then she turned to comments on Headdon's conclusions:

> "My understanding is that the conclusion you have reached is that if the House of Lords' judgment puts the Society in scenario 6, there will be a significant risk of mass transfers and surrenders and that you would regard this as a material change in circumstance.
>
> The judgment and its repercussions for the Society are themselves no doubt highly material matters in this context as well. It is also relevant that the figures in the annual statements will not take into account the suspension and the new reduced levels of non-guaranteed final bonus and would therefore, if used to calculate transfer, internal switch and surrender values, produce figures that are too high in any event.
>
> I gather that you have concluded that, in the exercise of your discretion and subject to any PRE constraints, the Society's practice on transfer and surrenders should be changed straight away if it transpires that a scenario 6 situation applies. This is because you believe that the material change of circumstance justifies this approach. The change would apply to all relevant policies.
>
> I assume that, on this basis, transfer, internal switch and surrender values would be reduced to a value at or near the guaranteed element of policy value, provided of course that the Society complies with the cash equivalent legislation where appropriate. Perhaps you would let me know how in practice you propose to determine the relevant values."

Then she turned to policyholders' reasonable expectations:

> "I am not sure what [if any] PRE constraints in fact exist here. Although I have not seen and reviewed all the relevant factors, I am aware that one of the notes to the 1999 annual statement is to the effect that *"the amount payable as a transfer to another pension arrangement or when switching from with-profit to unit-linked investment is not guaranteed and may be less than the guaranteed value"*. Clearly, this statement does not preclude a change in the Society's current approach and is helpful in making clear that policyholders should not have an expectation that transfer values will necessarily reflect non-guaranteed elements, or even the whole of the guaranteed element. I attach a note from [counsel] quoting the relevant passages from earlier annual statements. These are broadly helpful in negating a PRE to the effect that transfer values will necessarily be as large as guaranteed value and/or that such values should reflect both guaranteed and non-guaranteed elements. However, it may be that there is other literature which is also relevant and could point the other way. Further, PRE can be affected by past practice of the Society which obviously, as indicated above, could suggest a PRE that transfer values etc. will reflect policy values as stated in annual statements. If this is the case, it is clearly important that the change in circumstance is identified and used to justify a change in practice, if you believe that such a change is appropriate. Another factor, which may be relevant to the identification of PRE, is industry practice. My understanding from you is that the Society is more generous than at least some industry players and this may be a factor which you would wish to consider.
>
> As you will recall, on 11 November 1999 Paul Newman of Counsel advised that all the Society's literature should be reviewed in order to establish what PRE existed, and that if a discounting of transfer values etc. was to be introduced at that stage, the review should take place immediately. He also advised that as a practical matter the Board should monitor the position, and possibly

> record any change of policy in a Board minute. Counsel's concerns arose out of the need to take PRE into account. He stressed that the Society should ensure that it acts reasonably and consistently. At the same time, Counsel believed that, in considering whether to change its approach to transfer and surrender values, the Society would be entitled to take into account a material change of circumstances, such as a flood of transfer requests, provided the resulting change in policy was communicated to policyholders as early as possible.
>
> If you do decide to embark on a change of approach to transfers, internal switches and surrenders, it is clearly vital that the rationale for this is documented at the time and that the stated rationale makes clear that any relevant PRE has been identified and taken into account, that the change is communicated to policyholders, salesmen etc. as appropriate, and that the Board is at the least formally told of the change and its rationale, if it is not involved in the decision-making process itself."

Leslie then raised the importance of timing if a new approach was to be introduced:

> "... given that the current draft of the PR material is on the basis that transfer values etc. will be calculated on the basis in force when the instructions from the policyholders are received by the Society and the benefit of avoiding a situation where those who transfer early do so on better terms than those who wait a few days."

She finished:

> "I hope the position is clear, but if you have any queries do please let me know."

173. Notwithstanding the obvious strength of the opinions held by the Society's legal advisers, on this as on other matters, I consider that the Society's established practice in this matter was correct, and indeed was an inevitable consequence of the policyholders' reasonable expectations generated by past practice. The equation of the expressions 'full policy value' and 'guaranteed benefits', which appeared to underlie the legal advice, was consistent with the approach that had been followed by the Society's legal advisers in tendering advice in the course of preparations for and the prosecution of the *Hyman* case. Among other underlying factors was the interpretation of the expression 'related benefits' that remained a material factor in the approach adopted by the Society's legal team to the end.

174. The advice can, perhaps, best be tested by assuming a request for a transfer value in a rising equity market. If the Society's legal team were correct in their approach, the policyholder would have been entitled to a value determined by reference to the guaranteed benefits accumulated under the policy, and not by reference to policy value. The long-time reservation of the right to modify benefits depending on financial circumstances would have no application. The advice on the legitimacy of a market value adjustment would have been consistent with the view of the contract promoted by counsel. But it would not have been consistent with the Society's practice, nor with the representations made to policyholders. The express reservation of the right to alter benefits depending on current market conditions had meaning if and only if there was an element in the benefits members could reasonably expect to receive on maturity, or transfer, that was not guaranteed but remained vulnerable to market movements. In other words, policyholders' reasonable expectations, on the Society's consistent practice over the years, had to include non-guaranteed prospective benefits.

175. In the hypothetical situation referred to, the policyholder would have received a series of statements of the 'value' of benefits over a number of years. If he were a post-June 1988 personal pensions policyholder, he would have seen the net value of his contributions after the contractual expenses deduction, and prior years' declared reversionary bonuses, accumulate at 3½%, supplemented by the current year's additional reversionary bonus, and topped up to policy value by the non-guaranteed

final bonus. And, in most years, he would have been advised that future bonuses were subject to future market conditions, in one form of expression or another. If the transfer date occurred in a rising market, he would not have been advised of any risk that the advertised policy value would not be the starting point for determining the surrender value.

176. If the legal advice were correct, however, the transfer value would start from the guaranteed benefits, irrespective of the state of the market, and any uplift would have required a fresh exercise of the directors' discretion to allocate bonus in the special circumstances at the time, whatever the policyholder had been told in the past. The policyholder's response would have been that he had been led reasonably to expect that the policy value intimated to him had some reality, and that in a rising market the expectation generated by past communications was that he would not get less. He would have been advised of the risk of a reduction if markets were to fall, not that there was a risk of reduction if markets were rising.

177. The Society's practice in this respect was consistent with policyholders' reasonable expectations in general. The only doubt that arises is whether the Society was entitled to penalise a policyholder who was deemed to be selecting against the office by reducing what would otherwise have been the transfer value on an arbitrary basis. The general policy of paying full value was well advertised. The policy of reserving the Society's position relative to market values generally was similarly well advertised. The reservation of a discretionary power to cut transfer values on the basis of a subjective judgment that the policyholder was taking advantage of excess policy value without a good excuse was not well advertised. But that did not contribute to the Society's adverse financial position at 31 August 2001.

178. However, while it is necessary to have regard to these detailed discussions and differences of view in the final period of the Society's story, prior to the cataclysmic events of 2000 and 2001, it is even more important in the present context that they arose for debate only at that stage. The Society's practice up until the dates of these discussions had been informed by much more general considerations.

Expectations of Terminal Bonus

179. Reverting to the more general position, the reservation of the right to amend published values of accrued terminal bonus, in the bonus notices and other publications of the Society, would have qualified any reasonable expectation that the full amount of accrued terminal bonus intimated annually would be paid in all foreseeable circumstances. It would have been unreasonable to ignore the consistent warnings over time that changes in market conditions could undermine the capacity of the Society to meet the total calls on its resources implied by the allocation of terminal bonus. However, it appears clear that the Society could not have eliminated terminal bonus instantly so long as it continued to pursue growth, and so long as it continued to experience growth on the basis of its returns and to inform policyholders of its investment success. The expectation of future investment success that motivated management might be said to be the source of the obligation to acknowledge that as a concomitant of that anticipated success there was a requirement to recognise the financial implications either by making provision in some form to meet the expectations generated or by retaining general reserves sufficient to cover emerging liabilities.

180. I have already made reference to some points of more marginal significance. In each successive year, the interim rates applicable for the first three months of the calendar year were in the course of payment on maturities prior to 31 March. It is impossible to identify any reason of principle or practice for ignoring the liability to pay these sums in the accounts at the preceding year-end. Two thirds of the aggregate might typically have been paid before the accounts were signed off. And had there been a sudden collapse in equity markets undermining the capacity of the

Society to pay on its ongoing interim rates, the revision of the bonus declaration and publication of any new rates would have had to be intimated to members.

181. By the time of the lodging of the regulatory returns, six months' payments would have been made on maturities, and the Society, in later years, would have applied for and been granted a section 68 order permitting the use of future profits on a certificate by the appointed actuary that the profits would be realised in time. It is inconceivable that the statutory returns and associated materials could have been presented on a basis that reflected the expectation of future bonuses (on the gross premium valuation basis used by the Society), reflected the expectation of future profits in terms of the section 68 order, and applied a valuation discount rate that mirrored the Society's ongoing ability to generate positive future returns, if the reality were that the accrued terminal bonus intimated to members was valueless, or was expected to become valueless in a short period, with the result that intimation of current total policy value was a meaningless recitation of arithmetic unrelated to any reality recognised by the Society.

182. The total constituency of policyholders at any one time included individuals who had taken benefits in the immediate past and individuals who might reasonably be expected to take benefits in the immediate or near future. The Society had an intelligible policyholder maturity profile. The risk that accrued terminal bonus might be vulnerable to adverse market conditions would have been relative at any one time to the unexpired term to maturity ascertained from the Society's maturity data and market conditions. Short durations would have presented less difficulty than medium to longer term durations in a relatively stable market. In volatile conditions there would have been greater problems in the shorter term. But these were factors that had to be taken into account in the valuation generally.

183. In 1979, Ranson made provision for three years' future terminal bonus payments. In 2002, Nowell contemplated provision for two years' payments. The actual level of payments over the 1990s tended to be about 10% to 12½% of the aggregate accrued terminal bonus.

Table 14.2: Movements in reserves and final bonus paid, 1981 to 2000

Year	Long term fund	Movement	F.F.A.	Movement	Final & Interim Bonus Paid
1981	668		Est. 91		
1982	882	214	204	113	
1983	1099	217	337	133	
1984	1367	268	467	130	45
1985	1811	444	436	-31	
1986	2305	494	580	144	38
1987	2862	557	524	-56	53
1988	3545	683	618	94	75
1989	4704	1159	1001	383	100
1990	5576	872	210	-791	154
1991	6993	1417	375	165	152
1992	8562	1569	935	560	168
1993	11451	2889	1741	806	165
1994	12371	920	1174	-567	173
1995	14907	2536	1705	531	246
1996	17572	2665	1733	28	299
1997	21500	3928	2176	443	388
1998	25044	3544	3025	829	475
1999	28061	3017	4841	1816	508
2000	31235	3174	2311	-2530	544

184. The pattern of payments of terminal bonus appears from an examination of the Society's records. Table 14.2 above shows in particular the relative movements

in technical provisions and the investment reserve, later fund for future appropriations, and shows the amounts of final bonus paid. It indicates that there was no structural relationship between movements in the long-term provision and movements in the investment reserve or fund for future appropriation. The relative movements bear no arithmetical relationship to each other year on year or over time. Ignoring 2000, the long-term fund grew by approximately forty-seven times over the period covered. The investment reserve or fund for future appropriation grew by approximately twenty times. The difference was aggravated in 2000. Further there was no relationship between the investment reserve or fund for future appropriation and the terminal bonus paid. Terminal bonus payments increased over the period covered. Movements in the fund for future appropriation were, in relation to terminal bonus, wholly casual.

185. In 1983, the investment reserve was approximately 37% of the long-term liabilities (an average of just under 35% for the years 1982 to 1984). In 1999, it was approximately 17% (an average of 12% for the years 1998 to 2000). Over the period 1986 to 2000 terminal bonus payments increased by more than 14 times. Further from 1983, the mix of reversionary to terminal bonus shifted in favour of terminal bonus. The trend of provisions for long-term liabilities identified the need for investigation for the periods 1986 to 1989, when there was an inconsistent pattern of growth; 1990 when the long-term business fund fell; 1991 to 1993 when there was again an inconsistent pattern of growth; 1994 when there was again a material fall, and 1999 and 2000 that instructed the approach to the analysis of the Society's finances over time.

186. It would be inappropriate to be over-prescriptive in drawing general conclusions from such erratic values. However, the accelerating growth in terminal bonus payments was fairly consistent over time. And that pattern emerged whatever the current financial experience of the Society. The reasonable expectations of policyholders at any given time would have been that the pattern would be sustained in the reasonably foreseeable future in the absence of financial catastrophe. Had the Society recognised terminal bonus in its statutory accounts and regulatory returns on any basis consistent with PRE, its financial weakness would have been exposed throughout the 1990s.

PART VI: REGULATION OF THE SOCIETY

CHAPTER 15: BACKGROUND TO THE REGULATORY CHAPTERS

1. In chapter 6 I have described the mechanisms by which the financial strength of the Equitable Life's with-profits fund was weakened from the 1980s through the 1990s. From a relatively strong position at the end of 1982, the Society's reserves for future reversionary bonuses were exhausted by 1984. By 1987 at the latest, aggregate policy values including accrued terminal bonus (later re-named final bonus) exceeded the related assets at market value. The Society never reversed that position fully, and in 1990, 1994 and 2000 in particular, there were serious deficiencies in the with-profits assets available to cover the aggregate of the policy values intimated to members. Throughout the period, however, the Society met the tests of regulatory solvency that were applied, and in chapter 7 I have drawn attention to some areas of questionable regularity in the means by which that was achieved in certain cases.

2. In chapter 9 I have also looked at the way in which the Society was being run, the role of the Board and the approach of the executive. The financial strength and corporate governance of a life office are core issues for the prudential supervision of that office.

3. In the following chapters I will examine how the financial strength of the Society was perceived by the prudential regulators, and how they approached their supervisory task. From there I will go on to consider how they responded to the annuity guarantee issue, the relationship between prudential and conduct of business regulation, and the way in which they resolved the supervisory dilemmas that they inevitably faced as the crisis developed.

4. This chapter contains a brief outline of the regulatory regime and the more significant developments in it over the period covered by these chapters. There are also notes at the end on the priority markings assigned to the scrutiny of regulatory returns, the policy I have adopted in regard to naming officials and referring to their grades, and the availability to the inquiry of regulatory files and documents.

The regulatory regime

5. Aspects of the system of regulation of life insurance companies have evolved over a long time. The requirement for insurance companies to make detailed accounting and actuarial returns to the Board of Trade to enable the solvency of companies to be monitored dates back to 1870[1]. Regulatory returns have continued to be a major part in the regulatory process ever since. However, the formal authorisation regime, backed by a range of intervention powers was introduced in 1967. And as I have discussed in chapter 13, those regulatory powers were strengthened in 1973, at which point the concept of policyholders' reasonable expectations was brought into the statute. The statutory role of the appointed actuary also dates from this period.

6. Through the period covered by these chapters, the regulatory regime was governed by two main Acts of Parliament, the Insurance Companies Act 1982, and the Financial Services Act 1986. The first dealt with 'prudential supervision', the second with 'conduct of business' regulation.

Prudential Regulation

7. The 1982 Act consolidated the existing insurance companies legislation, incorporating a number of changes that had been made the previous year in order to

[1] Life Assurance Companies Act 1870.

implement the first generation of European insurance directives[2]. The basic structure and approach to regulation continued as before, with responsibility for supervision resting with the Secretary of State, and for day-to-day purposes with the insurance division of DTI, advised by GAD. The focus of prudential supervision was, and remains, the financial soundness of the insurer and its ability to handle the risks to which it is exposed and meet its liabilities. Thus the primary objective of insurance division, as defined in a 1995 service level agreement between DTI and GAD, was:

> "To regulate the insurance industry effectively (within the duties and powers set out in the [1982] Act) so that policyholders could have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations."

More recently, FSA, who assumed responsibility for this function on behalf of HM Treasury from 1 January 1999, summarised the objectives, in a statement prepared for the inquiry, as:

> "To protect consumers by ensuring persons or companies who are not fit and proper, appropriately resourced or soundly managed do not carry on insurance business in the UK.
>
> In supervising authorised insurance companies the main objective is to protect policyholders against the risk of companies being unable to pay valid claims. In the case of life insurance companies, this includes the risk that they will be unable to meet policyholder's reasonable expectations."

The significance of the PRE element is evident from these objectives. Also significant is the focus on the management of insurance companies. Under the 1982 Act DTI were also charged with considering whether an insurance company or its controllers (broadly speaking its directors and significant shareholders) were 'fit and proper'. From 1994 this criterion was augmented by another borrowed from the equivalent banking legislation, that of 'sound and prudent management'.

8. As noted already the regulatory returns provided the primary source of information on which supervision was based from long before the 1973 Act. This was the essential element of the long-standing policy referred to as 'freedom with publicity', whereby market discipline was relied on to support (and limit reliance on) direct supervision and intervention by DTI. As a DTI brief from the late 1970s put it:

> "The main purpose of insurance supervisory legislation is to protect the public from loss through the insolvency, dishonesty or incompetence of an insurer. The basis of the British system has been "freedom with publicity" - freedom for the insurers to determine their own premium rates, policy conditions and investment and other policies in return for publicity about their financial condition to enable solvency and general soundness to be monitored."

9. Thus, besides informing the regulators at DTI and their advisers at GAD, regulatory returns were public documents, and this transparency was relied upon to impose additional discipline on life companies by exposing details of their financial position to critical analysis by informed commentators (such as other life companies and independent financial advisers).

Intervention powers and PRE

10. The regulatory role of DTI was underpinned by various powers of the Secretary of State under the Act, including powers to require information, to withhold approval for new controllers, and to intervene in the running of the business in various ways, ultimately including withdrawal of authorisation to write new business and/or petitioning for winding-up. I have already described the background to the introduction of the term 'policyholders' reasonable expectations' (PRE) into one of the grounds for the exercise of a number of specific intervention powers under the

[2] Council Directive 79/267/EEC (1st life directive) and Council Directive 73/239/EEC (1st non-life).

1973 Act[3], as well as the sole grounds for the exercise of a new 'residual' power of intervention. These aspects were carried forward into the 1982 Act in sections 37 and 45 respectively, albeit that there was some alteration as a result of the implementation of article 21 of the 1st life directive[4] (see below).

11. As with any similar statutory power, the regulator was bound to consider not only whether the concerns about PRE were sufficient to justify its exercise, but also how it might be exercised in a manner that was appropriate to the purpose. And as with similar intervention powers in other regulatory fields, the regulator would have to balance a number of competing interests, for instance the expectations of several groups of policyholders, or the interests of actual and potential policyholders. I will come back to this latter point in my conclusions.

12. I have discussed the interpretation and significance of PRE at length already. The incorporation of PRE as a trigger for intervention, and particularly as the trigger for the residual power, effectively defined the regulatory purpose underlying the Act. However regulatory solvency was defined from time to time by means of regulations made under the primary statute, the residual measure to which the regulator had to have regard was PRE throughout the period with which we are concerned.

13. In view of some representations that have been made, I should make clear my view that the above proposition about the defining nature of PRE is not affected by the presence in the legislation of particular provisions which appear to have a more narrow focus. For instance, section 22(5) of the 1982 Act sets out the particular duties of the regulator in respect of the documents (annual accounts and regulatory returns) which must be supplied to the regulator under section 22(1). The regulator is specifically directed by this provision to consider whether the documents are accurate and complete, and is required to communicate with the insurance company "with a view to the correction of any such inaccuracies and the supply of deficiencies". In my view, this provision cannot be construed as defining, much less defining exhaustively, the regulator's interest in those documents or the relevant insurance company. Rather this is an example of a procedural provision designed to avoid the need to make recourse to weightier powers in respect of minor or routine questions such as might arise on preliminary examination of the documents. Performance of this task in respect of the returns is referred to in the following chapters as the 'initial scrutiny'.

14. A more substantial question about the use of intervention on grounds of PRE has been raised in representations from GAD. They have pointed to the notes on clauses from the 1973 Act which were quoted earlier[5], which stated that intervention would only be exercised where it was "obvious" that reasonable expectations were not going to be fulfilled, and that this would "stop well short" of seeking to ensure value for money or a particular level of bonus regardless of the surplus revealed by the periodic valuation. GAD cited this as the "best indicator available as to the intention of Ministers". That is as may be. But whatever the intention of Ministers at the time of the 1973 Act, and I have seen no evidence in the files that this was a current consideration in the period we are concerned with, the responsibility of the regulator was to consider whether the statutory test was met, or whether the powers were exercisable, and it was appropriate to exercise them, in the circumstances of the time.

Restriction on the Exercise of Section 45 to Restrict the Disposal of Assets

15. A particular issue has been raised about section 45 with which I must deal here. As a result of the implementation of the 1st directive, section 45(2) provided that the residual power under subsection (1) could only be used to impose a

[3] Chapter 13, paragraphs 9 to 32.

[4] Council Directive 79/267/EEC. Article 21 was subsequently substituted by article 27 of the 3rd life directive, Council Directive 92/96/EEC, and these changes were implemented by amendment to the 1982 Act by the Insurance Companies (Third Insurance Directives) Regulations 1994, SI 1994/1696.

[5] See chapter 13, paragraph 30.

restriction on the Society's ability to dispose of its assets where one of the specified circumstances in section 45(2) applied. Thus there must be (a) a prior direction, for example to close to new business, or (b) a failure to maintain RMM, or (c) a breach of the liability valuation regulations, or (d) a breach of the solvency or adequacy of assets requirements. In their maxwellisation representations, the Treasury[6] have drawn attention to the limitation under section 45(2) and suggested that a requirement to set aside reserves for non-contractual, non-guaranteed potential future terminal bonuses, might have involved such a restriction on the disposal of assets. Thus:

> "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."

The significance of this argument will become apparent, if it is not already, from the following chapters. I do not propose to indulge in an exhaustive discussion of the argument here, and I do not deny that there could be some circumstances in which this restriction on section 45 would be pertinent, but I do not consider it material to the events with which this inquiry is concerned for the following reasons.

16. First, section 45 was not an exhaustive statement of the power of intervention on grounds of PRE, as the Treasury acknowledge. Indeed section 37(6) made it clear that the residual section 45 power was available only where its purposes could not be achieved by any of the more particular powers specified. None of the more specific powers was qualified by section 45(2), so intervention on PRE grounds is therefore not qualified by section 45(2) in general. I also note that the Treasury have acknowledged that from 1994 the regulator had the option of closing the Society to new business if it appeared that "any of the criteria of sound and prudent management is not or has not been fulfilled, or may not or may not have been fulfilled", and that in those circumstances a restriction on the disposal of assets could have been imposed even if the Society was meeting its RMM. Closure to new business might have been a heavy-handed route to requiring more prudent reserves, however, and I am not sure that this would have satisfied the regulator's ambitions to 'light touch' regulation.

17. Second, it does not follow that where none of the pre-conditions under subsection (2) exist (i.e. a company is solvent, maintained its RMM, not subject to a direction to close to new business etc.), imposition of a requirement on that company to hold additional reserves, or in some other way to recognise a liability arising under PRE, would necessarily restrict its freedom to dispose of its assets, and therefore breach the subsection. Such an argument assumes that the company would otherwise be able to dispose of relevant assets. But requiring recognition of a liability based on PRE would not have that effect. The liability would have to exist before it could be recognised: it could not be conjured out of the air. It would be a

[6] In the course of maxwellisation I received representations from some of those who were subject to the process to the effect that in light of potential criticisms HM Treasury should be 'maxwellised' as an institution and thereby given the opportunity to respond. In the interests of fairness to individuals, given that certain of the potential criticisms were of the regulator or the regulatory system, and despite the difficulties inherent in seeking to maxwellise the department which commissioned the inquiry, I agreed to this. The Treasury were clearly as sensitive as I was to the need to ensure that such a process did not compromise the independence of the inquiry, and I note that a small team of officials was established within the department to respond to the inquiry on behalf of the department. I understand that the team reported to a member of the management board, but neither the team nor the member of the management board had direct policy responsibility for the area. The Treasury have also made clear that neither the material made available by the inquiry nor the response were shown or discussed outside this team, and particularly not with Ministers or those who would have responsibility for the handling of the final report. I cannot therefore treat the responses received as necessarily reflecting any settled view of Treasury officials, and most certainly not as reflecting the views of Ministers, who will have the opportunity to make their views known through Parliament in due course. References to the Treasury's maxwellisation response should be understood in this light.

function of representations made to policyholders that obliged recognition of the obligation. In that case the retention of assets would arise from the existence of the obligation, not from the requirement to recognise it.

18. Third, I am glad to note that the construction suggested by the Treasury bears no relationship to what was done by DTI, nor the terms of the Treasury's own service level agreement with FSA. The regulators acted as if they had power to investigate PRE with a view to taking action, and I believe that they were right to do so. They never got round to taking such action, but that is a different matter. It appears clear from the files that the senior line supervisor at the time, and those instructing her, would have been surprised indeed to discover that it was considered that their powers were constrained in this way. I also note that none of those involved at the time have sought to advance this argument in their own responses to maxwellisation.[7]

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.

<u>The Appointed Actuary</u>

20. The appointed actuary was another critical feature of the regulatory regime throughout the period. The appointed actuary had specific duties to report to the board on the financial condition of the company, and to advise the board on bonus distribution and the interpretation of PRE. These were not regulatory functions as such, but there were additional functions that had or could have regulatory implications. The appointed actuary was required to report to the regulatory authority if the board did not take his advice on certain matters, and that clearly was or might be a trigger for regulatory action. He was also required to certify schedule 4 of the regulatory returns, which showed the liability valuation. The latter function did not substitute for the regulators' performance of their duties, but it would clearly condition their scrutiny of the returns. However, it is important to note that the reporting requirements were constrained by the valuation regulations, which were the responsibility of the regulators, and these requirements could not be definitive of regulation. In particular there was nothing in schedule 4 that would inform the regulators about PRE.

21. It is also significant to note that the status of the appointed actuary could vary and did in fact vary considerably between different companies, consistently with the statutory and regulatory framework. In some companies the position might be held by a relatively junior functionary within the actuarial department, while in others the appointed actuary might be a senior executive, the combination of the position in Equitable's case with that of chief executive and reporting actuary for Companies Act purposes being at one extreme. In light of this, the reliance placed upon the appointed actuary by the regulators would have had to vary according to seniority and the potential for conflicts of interest.

22. Guidance on the professional responsibilities of the appointed actuary was issued from time to time by the professional bodies, the Institute of Actuaries and, in Scotland, the Faculty of Actuaries (in the guidance series referred to elsewhere in

[7] It is also significant to note that it would drive a coach and horses through FSA's proposals for realistic accounting and individual capital adequacy standards if it was considered that the directives ruled out action equivalent to requiring additional reserving in circumstances where it was not considered that a life office should be prevented from writing new business. However, I am satisfied that that is not what the directives require.

this report as GN1 and GN8). I have commented on this guidance as appropriate elsewhere in this report, particularly in relation to PRE. However, an important point to note in understanding the appointed actuary's role is that it made clear to the appointed actuary that the management of the insurance company was the responsibility of the board.

Conduct of Business Regulation

23. Conduct of business regulation was governed by the Financial Services Act 1986, which established a regulatory regime for the carrying on of 'investment business', implementing recommendations from the Gower Report and replacing the Prevention of Fraud (Investments) Act 1958. Those wishing to carry on activities regulated under the 1986 Act could either obtain authorisation from a 'designated agency' (the only one being the Securities & Investments Board (SIB), which later became the Financial Services Authority), or more commonly by becoming a member of a self-regulating organisation (SRO). The SROs derived their power to grant authorisation, through membership of the organisation, from being recognised by the SIB, and there were certain criteria to be met for recognition. The powers of the SROs stemmed from their contractual relationship with their members.

24. The provision of investment advice and selling of investment products, including life and pension products of the type provided by Equitable, were regulated activities under the Act, and the Society was a member of two SROs; LAUTRO, subsequently the PIA, in respect of its sales activity, and of IMRO in respect of its fund management.

25. Whereas prudential regulation was aimed at protecting the customer from investing with a financially unsound or unfit provider, conduct of business regulation was aimed at protecting the investor from investing in a product which was not suitable to his or her needs. As Martin Roberts, head of the life side of DTI insurance division from 1989 to 1992, told the inquiry:

> "Put simply, prudential regulation is about ensuring that the business is capable of delivering what has been promised. [Conduct of business] regulation is ensuring that what the policyholder is advised to buy is what the policyholder needs."

26. These two branches of regulation were clearly quite distinct. Whereas the focus of prudential regulation is essentially on running of the company as a whole, conduct of business is by its nature more focussed on how particular business is conducted. The regulators naturally had very different approaches to these tasks. In particular the focus of conduct of business regulation on particular transactions involved sampling techniques and site visits that contrasted with the holistic, though largely returns-based, approach of the prudential regulators. Jonathan Spencer, who was head of insurance division from October 1991 has commented to the inquiry that conduct of business regulation did not have a lot of bearing on prudential regulation, and that LAUTRO and the PIA were "viewed by the industry as a 'tick-box' regulator that did not take a holistic view". Roger Allen, who took over from Roberts in 1992, observed to the inquiry that:

> "The role of the prudential regulator was to monitor the financial soundness of insurance companies and to consider whether persons were fit and proper, and the sound and prudent management of companies as a whole. If there was a problem with the way sales were made, it would only be a matter for us if it was indicative of a more general management failure. This difference was most marked at the interface between the two regimes: for example, conduct of business rules did not apply to the administration of contracts after the point of sale. This was not so much a lacuna as an awkwardness."

27. I will come back to this "awkwardness". However, the potential impact of conduct of business regulation for the prudential regulators was recognised in the 1986 Act, which required the conduct of business regulators to contact DTI if they

wished to exercise powers that might have a significant impact on a life company. This was a requirement that would assume a greater prominence with the pensions mis-selling review. And as noted by Allen, conduct of business issues could potentially indicate broader grounds for prudential concern over the running of an insurance business. In the other direction, conduct of business regulators had an interest in the prudential side to the extent that prudential issues might inform the disclosure requirements they imposed on firms.

28. Interaction between the regulatory bodies seems to have been relatively limited in the 1980s. Roberts told the inquiry that during his period as head of the life side his contact with the conduct of business regulators tended to be on policy issues, and only occasionally over concerns about individual businesses, but there was also routine exchange of information at more junior level. Although more might have been done to improve communications more quickly, Roberts did not consider that communications were bad, especially considering the fact that the regulators operated under separate legislation and in separate buildings. Spencer also told the inquiry that he did not think that there were significant areas that fell between the two sets of regulators.

29. From 1992 there was some additional formalisation of the interaction through the mechanism known as a 'college of regulators'; regular meetings between various financial services regulatory bodies, hosted and chaired by the body perceived as the 'lead regulator' for a certain type of firm. For life insurers, this was DTI. Allen told the inquiry that the stimulus for these meetings mainly came from the banking and insurance supervisors, but other regulators were involved and did contribute.

The Single Regulator

30. In May 1997 the Chancellor of the Exchequer announced that responsibility for banking supervision was to transfer from the Bank of England to SIB, and that there was to be created a single regulator for financial services. In due course it was confirmed that the single regulator would have responsibility for insurance supervision.

31. The Financial Services Authority was launched in October 1997. This was followed by the transfer of responsibility for banking supervision the following June (a date referred to as "N1") under the Bank of England Act 1998. However, pending enactment of the legislation needed to give full statutory effect to the new regulatory regime, a number of administrative and contractual measures were taken to create the new single regulator. FSA assumed day-to-day regulatory responsibility on behalf of the SROs on the basis of contract, responsibility for insurance was transferred from DTI to HM Treasury under a transfer of functions order on 5 January 1998, and FSA assumed day-to-day responsibility for insurance from the Treasury on the basis of a contracting-out order on 1 January 1999.

32. The Financial Services & Markets Act 2000, which gave FSA direct statutory responsibility for insurance and conduct of business regulation, was brought into force from 1 December 2001 (this was "N2").

Scrutiny Priorities

33. The following chapters contain various references to a system by which the scrutiny of different companies' regulatory returns was assigned a priority. These priority markings are explained below.

34. In 1984 the respective responsibilities of DTI and GAD for the regulation of insurance companies were formalised in a service level agreement. DTI retained responsibility for taking formal action on behalf of the Secretary of State, and as such remained the primary interface with the company, but GAD were responsible for the examination of returns and were given discretion to pursue questions directly with the insurance companies (though they were not permitted to approach auditors directly, nor were they to contact appointed actuaries "in the first instance").

35. The agreement set out a scheme of priority ratings to be assigned to companies by GAD as part of their initial scrutiny of returns. The priority ratings and their consequences were set out in an annex to the agreement as follows:

- Priority 1 – Urgent: A company had failed to maintain its required solvency margin (RSM) or apparent weakness in the valuation basis suggested that the solvency margin might not be covered. GAD was to carry out a detailed examination within days of receipt of the company's returns.
- Priority 2 – High Priority: A company had maintained its RSM, but its declared margin was less than 125% of RSM and there was no reason to suppose that significant hidden margins existed, or a company appeared to have failed to comply with the regulations in material respects. A detailed examination was to be carried out as soon as possible. Even less urgent companies in this category should normally all be examined within four months of the due date for the returns.
- Priority 3 – Medium Priority: A company had a declared solvency margin of between 125% and 200% of RSM, or lesser declared cover but with significant hidden margins, or a higher solvency margin cover but there were doubts over certain aspects of the returns. A detailed examination should normally be carried out within ten months of the due date for the returns.
- Priority 4 – Low Priority: A company appeared to have a solvency margin of at least 200% of RSM having regard to the likely level of hidden margins and had no obvious problems of compliance, or its business was inherently low risk and its solvency margin appeared adequately covered. A detailed examination was to be carried out within twelve months of the due date for submission of the returns. Thereafter a detailed examination was to be carried out at least once in every three years.

The agreement was to be reviewed in early 1986, though the inquiry has seen no evidence that it was reviewed until a further agreement was agreed between Spencer and the Government Actuary, Chris Daykin, in March 1995.

36. In general, the 1995 service level agreement followed similar lines to the 1984 one. It confirmed that the insurance division had sole responsibility for all executive decisions taken in the exercise of the powers under the Act, and clearly defined GAD's role as advisory, although it acknowledged that it would not be possible to document or anticipate all instances where GAD's advice would be sought. A close working relationship was required. Except in special circumstances, GAD were to accompany DTI officials on all visits to companies, and be given the opportunity to attend all meetings held by DTI with companies. GAD could also hold meetings with companies on actuarial issues, although they were required to notify DTI, and offer them the opportunity to attend.

37. By this time the 4 priority ratings had become 5, although none of the copies of the 1995 agreement which the inquiry has seen set these out.

38. A further agreement was drawn up in October 1998 to reflect the transfer of functions from DTI to HMT. This followed the 1995 agreement and a table setting out the 5 priority rating scale was attached. As well as the description of each priority rating, there was a list of other indicators which were subordinate to the description, and were merely to give some broad assistance. It was stated that they were no substitute for judgement, both where a higher or lower priority might be justified. This ratings, descriptions, other indicators, and the targets for completion of detailed scrutinies were as set out in table 15.1 on the page opposite.

Table 15.1: Five priority scale under 1998 service level agreement

Priority	Description	Other indicators	Target
1	A company which either is not demonstrating that it holds the required minimum margin (RMM), or else where there are significant problems which lead GAD to believe that it does not meet the requirements under proper bases		Within two weeks
2	Companies where there are significant and substantial concerns	1. Cover for RMM less than 1.25x 2. Evidence of material non-compliance with valuation regulations	Within four months
3	Companies where there are sufficient concerns to warrant early attention, or there are other reasons to require scrutiny early in the cycle	1. Cover for RMM less than 1.5x 2. Evidence of non-trivial, but not material non-compliance with valuation regulations 3. Company was in priority 1 or 2 the previous year 4. A company visit is scheduled for September to January (or equivalent for those with non-December year-ends) 5. Company had commenced trading, but was authorised for less than 18 months at the valuation date	Within six months
4	Companies which warrant a full scrutiny for any reason, but would otherwise not fall within a category to ensure this	1. Cover for RMM less than 2x 2. Company was in priority 3 in the previous year 3. Evidence of non-compliance with less important regulations 4. Company did not receive a full scrutiny in either of the previous years 5. A company visit is scheduled for February to August (or equivalent)	Within nine months
5	Companies which do not qualify for priority 4 or higher after the initial scrutiny	Cover for RMM is more than 2x and scrutiny was in last 2 years	Within eleven months

Names and Grades of Officials

39. During the period for which the inquiry has detailed evidence, the staffing levels available to the prudential regulators varied, but the number of staff with direct responsibility for the Society and their grades within the civil service remained broadly constant.

40. The first point of contact between the Society and DTI was the line supervisor, a higher executive officer, who reported to a more senior line supervisor, who was a senior executive officer at the start of the period, but was later replaced by the more senior 'grade 7' level (formerly known as a 'principal'). For ease I will refer to these positions as the 'line supervisor' and the 'senior line supervisor' throughout.

41. The senior line supervisor reported to the head of the life department (or branch), who was a 'grade 5' (formerly 'assistant secretary'). The head of life in turn reported to the head of insurance division, who was a 'grade 3' (formerly 'under secretary').

42. At GAD day-to-day contact with a life office's returns, and from time to time with the executives of a life office, would have been at the grade described simply as 'actuary'. I have referred to officials of this grade as 'scrutinising actuaries' to avoid the difficulties that would arise from use of the generic term. It was the scrutinising actuary who normally wrote the scrutiny reports prepared to inform the regulators of GAD's assessment of the actuarial position of the office.

43. The scrutinising actuary would report to a 'principal actuary', and although that title was superseded during the reference period by 'chief actuary', I will use the former term for case. The principal actuary would report to the 'directing actuary',

who would in turn report to the Government Actuary, who was the head of the department.

44. In preparing this report, I have sought to avoid identifying particular individuals, particularly relatively junior officials, where I have thought it unnecessary to do so to give the reader a proper understanding of the events described. However, where officials held senior positions, or played particularly significant and complex roles, I have taken the view that it is appropriate to identify them by name. Broadly speaking I have identified by name all those DTI and Treasury officials at grade 5 and above, but not the line supervisors and senior line supervisors. Similarly I have named the GAD actuaries at principal and directing actuary level, but not the scrutinising actuaries. However, where an individual has played a part in these events at different levels, for instance as scrutinising actuary and then as principal actuary, I have named that individual throughout.

Availability of Regulatory Files and Documents

45. The Department of Trade & Industry, HM Treasury and the Financial Services Authority have made available all the extant files that the inquiry team was able to identify as being of relevance to the inquiry. However, there were deficiencies in the recoveries, and I have not been able to assess the impact that may have had on the authority of this part of the report. This note sets out those deficiencies.

DTI correspondence files

46. There are no DTI correspondence files dealing with Equitable for the period prior to 1991. A group of earlier files was destroyed, presumably as part of a broader review of the insurance files, in 1998. When the inquiry sought clarification of the basis for the decisions to destroy these particular files, DTI provided a document from 1986 that set out a proposed policy on retention and destruction of the department's insurance files. Broadly speaking the policy was that certain types of fairly routine files, including those containing the regulatory returns for particular companies, would be reviewed for destruction after ten years, while the bulk of the files, including general correspondence relating to specific companies, should be preserved for twenty-five years. Because the division between correspondence and returns files had not always been observed in the past, the author of the 1986 note proposed that those files which apparently fell into the category for destruction after ten years should be reviewed, "with a view to destruction provided that the contents of each returns file were entirely routine papers about the return". Otherwise a further judgement needed to be taken about the likely importance of the papers.

47. Subsequently in 1993 there appears to have been a substantial review of the old insurance division files, going back to the early 1970s, as a result of which many old files were destroyed and the general files concerning Equitable up to 1991 were marked for destruction in 1998. That destruction appears to have taken place on the 'destruction bay' date without further review. I understand that that was the departmental practice at the time. Unfortunately for this inquiry the outcome of the 1993 review appears to have been almost a complete reversal of the 1986 policy, with all the general correspondence files for the Society before 1991 destroyed, while the regulatory return files were still available (albeit incompletely) back to 1981. It is difficult to see a reason for this reversal of practice.

48. The reviewer in 1993 was an experienced officer who had worked in the insurance division. In a memo to the head of DTI archives on 26 May 1993 he indicated that, although the bulk of the older files were being destroyed, with less than 20% being retained even for review in 1998, he regarded this as a relatively high proportion of retentions. He explained that there were two reasons for retaining as many as he did:

> "First, a lot of files could be of administrative use for a long time or even indefinitely. The business of insurance is aptly personified as an animal with

a long tail. Second, the insurance industry and those who had a duty of supervising it were going through interesting times (in the sense of the Chinese curse) when these files were raised."

49. The principles applied in the 1993 review were set out at some length. The reviewer listed the following as his first principle:

> "I[nsurance] Division carried out an exhaustive and on-going supervision of any insurance company which shewed (*sic*) signs of being "unable to meet the reasonable expectations of its policyholders", in other words of becoming insolvent. It was particularly alive to companies which were behaving improvidently in any way, or were even being what in other businesses would have merely been considered "sharp". I have generally retained the files that record this sort of supervision on the grounds that a few of these companies may actually go bust, which could call for an historical examination of their decline."

From this it might be concluded that the files did not show, in the view of the insurance division, any evidence of concern over the Society's ability to meet PRE, or any suggestion that it had been behaving improvidently. I have found no evidence of any questionable motive related to Equitable in particular. But in the absence of the files it is impossible to form any view whether PRE issues were considered and dealt with in a way that excluded concern about the Society's ability to meet PRE or simply not considered at all, to take the extremes of the spectrum of possibilities.

50. The reviewer clearly recognised both the long-term nature of insurance business and the potential future interest in events even long past. Unfortunately he appears to have been trying to assess that potential future interest in terms of whatever assessment of PRE was evident from the contemporary record. Given the decision in 1973 that PRE was to be assessed solely on the basis of the returns[8], it is perhaps unsurprising that this gave rise to so few retentions. One would be slow to fault the reviewer on the basis that he did not pick up concerns about the Society if, as one must assume, such concerns were not recorded in the documents.

51. The department has subsequently pointed out to the inquiry that, although the document from 1986 was initially supplied in response to the inquiry's request to see the applicable rules on destruction, it only constituted its author's suggestions for "broad ground rules" and that the author himself conceded that they were rather arbitrary. DTI have further commented that these broad ground rules were in practice "too broad to implement". The department also pointed out to the inquiry that the 1986 document established an expectation that "most files" should be destroyed after 25 years, that quite a few files would warrant destruction between 10 and 25 years, and described certain categories of files that might warrant longer retention. It was, the department observed, unclear into which of the categories described in the note the Equitable correspondence files would fall. The department does not accept, therefore, that there was any reversal of policy.

52. I have no wish to extend discussion of departmental record-keeping, but given the recognition by the DTI reviewer that life insurance is an animal with such a long tail, it is regrettable from the inquiry's point of view that the department did not follow more closely the spirit of the 1986 note. Had they done so, they might have been less inclined to destroy the main file series relating to Equitable without further review, especially given that some of the papers would have been little more than 2 years old at the time that they were consigned (apparently irrevocably) to destruction in five, not twenty-five, years' time. This inquiry might then have been able to form a much clearer view on certain important aspects of the Equitable story, in particular the regulatory issues raised around the switch from retirement annuity contracts to personal pensions in 1988.

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[8] See chapter 13, in particular paragraphs 24 to 27.

Indexing of DTI and GAD files now held by FSA

53. Leaving aside the Equitable-specific correspondence files, a great many of the older regulatory files covering a wide range of policy and supervisory issues have been transferred to the FSA. Where it has been possible from the old DTI and GAD indexes to identify relevant files, these have been made available. However, the FSA holds a very substantial body of files (about 30,000) for which it has no single reliable index. The inquiry has been able to select such files as it could identify as potentially relevant from the lists that are available, and the FSA has told the inquiry that a more rigorous indexing of these files would involve disproportionate cost. I have reluctantly accepted this and have not insisted that the FSA re-index these files as the prospect of identifying additional relevant files did indeed appear slim. However, it remains unsatisfactory that such a large body of the regulatory archive is so poorly indexed.

CHAPTER 16: REGULATION UP TO 1997

1. The scrutiny reports on Equitable's regulatory returns from the mid to late 1980s were relatively brief; terse documents, normally running to a page or a page and a half. They were prepared by GAD following their scrutiny of the very much more voluminous regulatory returns that life offices submitted six months after the year-end to which they referred. The scrutiny reports would record a few headline figures, the amount of new business written, the movement in mathematical reserves and the cover for the required minimum margin (RMM) of assets over liabilities. This was typical of the length and depth of the scrutiny reports at this period according to the senior executive officer responsible for supervising the Society at the time.

2. Equitable was consistently given a priority rating of 3 during this period[1]. In terms of the 1984 agreement between DTI and GAD, that rating implied that the Society (a) had a declared solvency margin of between 125% and 200% of RMM, or (b) had a lesser declared cover, but significant hidden margins, or (c) had higher solvency margin cover, but doubts existed over certain aspects of the returns. In category 3 cases, an annual scrutiny was required and GAD's detailed examination was normally required within ten months of the due date for submission of the returns to insurance division. In the event, the period that elapsed before the scrutiny was completed varied considerably from year to year, from September 1987 (ie 3 months) in respect of the 1986 return to March 1987 (9 months) in respect of the 1985 return.

3. The Society's cover for the RMM was clearly a key index. It was dropping through the mid to late 1980s, from 8.5x (that is free assets were eight and a half times the amount determined under the regulations as the minimum margin) in 1984 to 3.8x in the 1988 returns. Of the categories specified in the 1984 agreement, only (c) appears obviously to apply. In the absence of the correspondence files[2] it is not possible to say exactly what doubts may have existed over the returns, or how the downwards trend in cover for RMM was regarded, but it would not appear to have been an issue of any great concern to regulators. The regulators would have been aware of the rising trend in new business, and should have been aware of the Society's change in practice from maintaining reserves for future reversionary bonus and the concomitant increase in terminal bonus allocations.

4. The scrutiny report for 1986, the first year for which an annual return was required, noted that:

> "... the Society has made reductions in the bonus rates for reversionary bonuses on all classes of policies. To compensate for these reductions the Society has increased the rates of Terminal Bonuses paid on all policies. We understand that this means that there is unlikely to be any overall reduction in benefits payable at the maturity of the policy."

The report concluded that no questions needed to be raised with the Society. But GAD had focused on distribution policy as a matter requiring comment in the scrutiny report.

5. The source of GAD's information about the increased terminal bonus was not disclosed. In 1986 the Society had changed the presentation of bonus information, consolidating the earlier interim and terminal bonus rates and, in the words of the appointed actuary Ranson, it successfully 'fudged' the press release that published the year's results. The terminal bonus rates underlying the new unified rate were at the same levels as had been paid in 1986 on the basis of the 1985 results, but the 'marketing adjustment' was used at sensitive durations to inflate returns. It is

[1] See previous chapter.

[2] And possibly some scrutiny reports. No scrutiny report has been found for 1987 or 1988. See paragraph 7 below.

difficult to reconcile the Society's records of distribution policy for the year with the GAD scrutiny report, but GAD's observations would have been accurate over a period of recent prior years.

6. The observations alerted DTI to the move in bonus mix from reversionary to terminal bonus that would become a central feature of subsequent years' distribution policy and put DTI in a position to consider what this might mean for the policyholder. The scrutinising actuary who prepared the report has referred to this part of the report as indicating:

> "... a trend towards a more cautious bonus policy. Equitable was maintaining the same level of overall bonus but with a lower reversionary of guaranteed element, which GAD would see as a good trend".

There is no indication within the available documents of any realisation by GAD or DTI that such an approach implied that, while there would be no material change in total returns to policyholders, there would be a reduction in the extent to which the overall distribution practice of the Society was subject to regulatory control through the scrutiny process. In their representations to the inquiry, GAD have observed that this was a 'good thing' in that it reduced strain on the Society's solvency position, which was GAD's "primary concern", and in respect of which terminal bonus was irrelevant.

7. No scrutiny report has been found in either DTI or GAD files for 1987 or 1988, and the inquiry has been told by the then principal actuary, Michael Pickford, that it is possible that no "detailed scrutiny report" was prepared because GAD were involved in a recruitment drive around this time to fill various vacancies. As may be apparent from the analysis in chapter 6, these years were crucial. 1987 was a poor year for the Society in the markets, seeing a net investment return of less than 9% and a total bonus allocation of 11½% (including ½% terminal bonus). 1988 saw a better return, 15.1%, which was almost entirely allotted as bonus. The Society's available assets were insufficient to cover total policy values at the end of each year.

1989: Introduction of the Managed Fund Approach

8. 1989 was the year in which the managed fund approach, which was indicated in about 1986, and was outlined in *With Profits Without Mystery* was implemented in full. The DTI return file is not available, so it has not been possible to discover what priority rating the Society was given in this important year. By the date of completion of the 1989 scrutiny report, December 1990, the markets had fallen drastically. The usual scrutiny pattern was changed. There was a meeting between the GAD actuaries responsible for the scrutiny and the Society's senior actuaries (Ranson and Headdon, two of the authors of the seminal paper) on 14 November 1990, ahead of the completion of the scrutiny for 1989, but looking forward to the end of 1990. The reason for the meeting was recorded in the minutes as being:

> "To see what the Society's solvency margin and financial position are likely to be at the year end."

9. Paul Burt, who was the principal actuary and who led for GAD and prepared the minutes, has told the inquiry that the meeting was called because of "comments made by Mr Ranson to Mr Pickford and by other people". Pickford, who was by then the directing actuary, recalled that at about this time:

> "DTI and GAD were beginning to adopt a more interactive approach with about a dozen or so companies we would shortlist, in which we would hold meetings with the company and its Appointed Actuary when the stock market had fallen, to get a prospective view on what the financial position was expected to be at the year end and what bonuses were likely to be declared."

10. Clearly the focus of the meeting was on the adverse market conditions that were then being experienced. Various current and projected figures were provided by

Ranson and Headdon at the meeting, including information that at a recent date the Society had an excess of assets over liabilities of only £55m, that a 10% rise in the value of equity assets would increase this to £580m, while a decrease of 10% would produce a deficit of £420m. It was observed that total free assets could be improved to as much as £755m if outstanding new business strains were released and a higher rate of interest was used in the net premium valuation.

11. The minutes recorded that Ranson was considering not paying any reversionary bonus for 1990. He also raised the possibility of applying for a section 68 order for future profits[3] and was assured that such orders would normally be available upon application, subject to approval by GAD of the figures. The discussion covered the possibility of weakening the valuation basis. However, Burt expressed concern about the position of the Society, particularly if the market were to fall any further or even remain at its present level. Ranson acknowledged that if the market fell by a further 20% they would "have problems and he would have to consider what action should be taken. He implied that at such a point he would have to consider reducing the level of new business taken on".

12. The record of the meeting ended with two comments:

> "1. Mr Ranson states that the Society is solvent. However as he is considering not paying a reversionary bonus this year (while at the same time paying terminal bonuses), he must be feeling very uneasy about the current position of the Society.
>
> 2. We are carrying out a detailed scrutiny of the 1989 returns in order to get a better feel for the position of the Society, and in particular for what margins there are in its current valuation basis and in the alternative net premium basis."

13. The note of the meeting was sent under cover of a memo on 22 November 1990 to Martin Roberts. The memo discussed the possibility of a weaker liability valuation, but went on to note:

> "Whether the Society is strong enough to declare a reversionary bonus for 1989 [*sic*] and still have sufficient available assets to provide for future contingencies is a matter for the Society's actuary and its Board.
>
> We are carrying out a detailed scrutiny of the 1989 returns, and will advise you if any further points arise."

One copy of this memo included a further comment, probably from one of the DTI supervisors, addressed to Roberts and copied to the actuary:

> "If the Equitable is not going to declare a bonus we need to warn the Minister before it becomes public. Will there be publicity? What about Equitable's advertising? Does it need to be changed?"

14. The scrutiny of the 1989 returns was completed on 5 December 1990. The report was only a page and it recorded that total premiums received were again at record levels (and significantly included nearly twice as much single premium business as regular premium income). The valuation basis was said to be satisfactory and the cover for the RMM had risen slightly to 4.77x. The report made no reference to any change in the approach to bonuses, simply noting that the Society had declared unchanged bonus rates. However, the report noted that:

> "If the property values remain depressed and the equity market does not show any bullish tendencies in the [*sic*] 1990 and beyond, we think that the Society may have problems in maintaining the current bonus rates ..."

The report also noted that there were a few queries for the company but that it was not anticipated that the response thereto would affect GAD's view of the solvency position.

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[3] See chapter 7 and paragraphs 30 to 34 below.

15. The scrutiny report reflected the focal points of GAD interest in the Society's affairs at that time: the exceptional growth in premium income, with the main contributor being the Society's personal pension plan; the proportion of the non-linked assets invested in low yielding equities and properties (two-thirds); that the Society had declared unchanged bonus rates and that 94% of the total cost of the bonus had been financed by transfer from the investment reserves; and the sustainability of the level of distribution if property values remained depressed and the equity market did not show any bullish tendencies.

16. The scrutiny report for 1989 did not disclose an appreciation of the significant change in the Society's bonus distribution practice advertised in *With Profits Without Mystery* and given effect in the bonus notices and other publications of the Society during the year. Nor did the report draw attention to the overall position of the Society at the time. Reversionary bonus had remained at 7½%, but terminal bonus had in fact risen substantially from 4% to 9%, giving a "total growth rate" of 20%. The Society had retained some 6% of its total return for the year, off-setting in part the over-distributions of earlier periods. But aggregate policy values were still in excess of assets at the inflated market values that applied at the year-end. The records demonstrate that regulation, and GAD's advice, were focused exclusively on the solvency margin over contractual liabilities and took no account of accrued terminal or final bonus, notwithstanding that at the date of the 1989 report exposure to falling markets was real and was known to GAD and the regulators.

17. GAD's queries on the 1989 return were set out in a letter to Ranson. Amongst other things the letter referred to the 14 November meeting and asked Ranson to confirm what investment return was required to support the current reversionary bonuses and those bonuses plus the terminal bonuses. Ranson replied on 17 December. He stated that the rates of declared bonuses required 11¼ % for the pensions business and around 8% net for the life business. In answer to the point about terminal bonuses, he set out the implications of the managed fund approach for the presentation of policyholders' benefits:

> "As you know ... we do not have the final bonus scales in conventional form. Rather, we announce a 'total growth rate' in policy values which gives the total accumulated policy value at the declaration date. The final bonus element in that value is the difference between the total value and the value of the guaranteed policy benefits at that date. The question of what rate of growth is needed to support 'current reversionary and final bonuses' is not, therefore, meaningful in our case ... You will also have seen from our With Profits Brochure that we emphasise that future bonuses must depend primarily upon future investment returns."

18. This statement of current practice reflected the substantial departure from previous practice. Prior to 1989 the Society had determined the terminal bonus by reference to specific scales of rates, but the new system meant the announcement of a total rate of growth with the terminal bonus being the difference between a policy's total value (ie guaranteed and non-guaranteed) and its guaranteed value. It is not clear how the adoption of the new system rendered the enquiry meaningless, unless Ranson's view was that the total allocation approach was so far removed from conventional actuarial thinking that the distinction between the reversionary and final bonus elements of the aggregate had no meaning, a view with which the Society's with-profits policyholders might well have agreed. However, on any view the Society had informed regulators of a new bonus practice that it presented as uniquely distinguished from bonus systems that identified reversionary bonus and terminal bonus as components of total allocation. In the Society's case determination of total return was the initial step, and final bonus was the difference between that initial value and the amount consolidated. This might have been expected to have provoked a question about the character of the total allocation.

19. Roberts and Pickford discussed the Society the following day. The note of that discussion shows that Roberts had picked up the concern about a failure to pay a

reversionary bonus and the position of those who had responded to recent advertisements, who "might have justification for wondering whether their reasonable expectations would be, or were being, met". Roberts wanted the Society to check their advertising to ensure that no such complaint could be justified, and it was agreed that a call from Pickford to Sherlock would be the best way by which to achieve this.

20. Burt sent a memo to Roberts the following day, 19 December 1990, picking up the issue of whether policyholders' reasonable expectations would be met or not met in the event of Equitable not declaring a reversionary bonus. In respect of policies maturing in 1991, he concluded that PRE would be met because the Society had indicated that on those policies they would pay interim reversionary bonuses at the 1989 rates, and that terminal bonuses would still be maintained at the appropriate level. Thus "there is likely to be no big change in total bonus payments at maturity". In respect of policies maturing thereafter, Burt considered a number of options open to ELAS and concluded that:

> "In effect, total maturity proceeds would be maintained though... less would come from reversionary bonuses..."

On balance, therefore, Burt concluded that PRE had not been breached, even in respect of maturing policies. The memo did, however, sound a note of caution if there was another bad year, as a result of which the company could not establish sufficient mathematical reserves to cover current guaranteed levels of benefits. That, he said, would be "a different matter". However, his approach made explicit the relationship between policyholders' reasonable expectations and aggregate maturity proceeds; whatever the bonus mix, reasonable expectations would be focused on what was paid out.

21. Burt then ended with a surprising conclusion about the way forward:

> "At present we do not have enough information about the society to be more specific and indeed, unless the society makes more signals, we do not suggest that further information should be sought. The society is our longest established life company and is well respected in the market."

The Society, it appears, was too venerable to be of real concern, and lack of information provided grounds for inaction. The risk of undermining market confidence in the Society appeared to influence regulators at later stages as well as at this time. Regulators had been given an insight into the Society's practice that might reasonably have alerted them to a need for monitoring of current and future practice. No special steps were taken to put in place a suitable system.

22. In the meantime, Pickford had called Sherlock, as he reported in the memo to Roberts recording their earlier discussion. The Board had met earlier that day, and it was now "pretty unlikely" that the Society would be unable to declare a bonus for that year. Ranson had presented a paper to the Board about the constraints on bonus policy emanating from the valuation regulations. The Board had also received a report from the investment committee predicting that the Society's investment performance in 1991 would be quite strong. The view of the Board, according to Sherlock, was that "the crunch position for the company would probably come next year". Pickford noted that both he and Sherlock had acknowledged the risk in a strategy of declaring a bonus for the current year in the expectation of improvements in the following year, and he concluded by stating that, if the market fell considerably in the future, urgent talks would be needed with the Society's actuary (as they would be with other companies in a similar position).

23. Although there were clear concerns, the implication of the memos from both GAD actuaries was that no further action was required. The documents available to the inquiry do not reveal any further follow-up to the issues raised at the 14 November meeting and in the memos that followed. Burt wrote back to Ranson that same day saying that the information supplied in the 17 December letter had been most helpful, and that there were no further queries on the 1989 returns.

24. GAD wrote to DTI on 4 January 1991, enclosing Ranson's letter of 17 December with the comment:

> "Mr Ranson has replied to our queries and we are satisfied with his answers of all our questions, consequently our detailed scrutiny of Equitable's 1989 return is closed."

Roberts' view of this period and the next year or two, as communicated to the inquiry, was that the Society was a bit weaker than was desirable, and DTI wanted reassurance. But Ranson appeared to have a good grasp of what was going on, and "had his hands on the right levers". The Society still had room to manoeuvre.

Treatment of Terminal Bonus

25. The scrutiny had been concluded with no reaction to Ranson's explanation of the Society's approach to terminal bonus. A fundamental change thus went by un-remarked. Given the level of publicity within the actuarial profession that had attended the presentation of *With Profits Without Mystery* and Ranson's observations on the uniqueness of the Society's practice, it is difficult to understand the apparent lack of interest in the new practice that was displayed, particularly by GAD. With the benefit of hindsight one can assess the consequences. But at the time an assertion of how different the Society's practices were from other offices might have been expected to alert regulators and their advisers to the need to take some interest in the Society.

26. I have already discussed the process of negotiation at European level of the 3rd life directive[4], the ultimate permissive treatment of reserving for future terminal bonus, and the implementation of the directive in the UK without requiring provision to be made for accrued terminal bonus. The approach of DTI and GAD over the period 1989 and 1990 reflected the established view of regulators and their actuarial advisers prior to the agreement and promulgation of the directive and domestic implementation of its provisions. There was no requirement to set up reserves for terminal bonus. It could properly be accounted for on a cash basis.

27. As a result, from the middle to late 1980s, Equitable's regulatory returns failed fully to reflect the way in which the business was actually run. To repeat part of what had already been said about *With Profits Without Mystery*:

- the key consideration for the Society was the most appropriate way to pass on 'asset shares' to policyholders;
- the manner of how those proceeds were made up between declared and final bonus elements was said to be of secondary importance; and
- the choice of declared bonus rates was arbitrary, though one had to have regard to the marketing implications of any decision.

If DTI and GAD understood that that was the Society's position, concentrating scrutiny and regulation on contractual benefits is difficult to understand in the case of Equitable, whatever the position in the rest of the life industry. But it was consistent with the way information was sought on a routine basis and with the established approach of the regulators and their advisers.

28. In practical terms, the shift of balance from reversionary to terminal bonus foreshadowed in the 1987 report was now pronounced. It had risen sharply to 35% in 1988 and 55% in 1989. No mention of this was made in the scrutiny report. The Society's new approach to presenting bonus meant that the proportion of aggregate policy values to assets was available for the first time, if DTI or GAD had sought the information. Examination of this aspect of the Society's practice would have revealed that, despite a total allocation well below the investment return in 1989 (20% as against 26%), policy values accounted for 104% of available assets, which in turn

[4] Council Directive 92/96/EEC, see chapter 10.

might have revealed a substantial deficit brought forward from 1987 or before. But this information was not required as part of the returns, nor was the Society asked to provide it otherwise at this stage.

29. At the time of the scrutiny of the 1989 returns GAD were clearly worried about the position emerging in 1990. Discussion at the 14 November 1990 meeting indicated quite serious concern. However, what little discussion there was following this meeting seemed to focus not upon the inherent weakness of the Society, but upon the risk of short term fallout from a failure to declare the bonus. Both the Board and the regulators seemed to have crossed their fingers and hoped for an improvement in 1991, instead of facing head on the reality that the Society's policy of full distribution, which was now clearly articulated, left them very exposed to adverse market conditions. The recommendation by Burt that DTI do nothing[5] unless asked to by the Society is difficult to understand, especially with hindsight. It was made at a time that has turned out to be have been crucial for the Society and its policyholders, but Roberts has denied that it was indicative of any complacency or lack of will on the part of DTI.

Future Profit Implicit Items

30. The first mention that the Society made of future profits implicit items was in the meeting with GAD on 14 November 1990. On 20 December the Society duly applied for its first section 68 order for a future profits implicit item (for £250m). Section 68 of the 1982 Act provided that the Secretary of State could, on application from an insurance company or with its consent, issue orders suspending or modifying the application of specified provisions under the Act to that particular insurance company. Among the provisions that could be suspended or modified was section 18, which required the periodic valuation of liabilities in accordance with any applicable valuation regulations. The regulations dealing with implicit items were regulations 10 to 13 of the 1981 regulations[6] later superseded by regulations 23 to 26 of the 1994 regulations[7].

31. As explained in chapter 7, the inclusion of future profits implicit items in the calculation of regulatory solvency was ultimately governed by the 1st life directive[8], which required the provision of supporting evidence. Under the directive and the regulations, a full future profits value was calculated which was, broadly, the product of the average annual profits on long-term business over the five preceding years and the average number of years of outstanding duration on policies, subject to a maximum duration of ten years. Up to 50% of the full value calculated in this way could be used to supplement the computed solvency margin. The average years remaining to run on policies was weighted by the value of benefits.

32. Guidance on applying for implicit items had been issued on 5 October 1984. This referred to the requirement for a certificate signed by the appointed actuary to the effect that the amount claimed was the lower of the product of the calculation described above and the "present value of the profits that may be expected to arise in the future on the long term business in force on the valuation date". The actuary's assessment of the latter was to be based on "cautious assumptions in regard to the future experience, in many respects similar to those required for the minimum basis for calculating mathematical reserves". Where the department considered it necessary, information could be sought from the actuary regarding those assumptions, though a statement of the basis did not need to be included as part of the application.

33. Roberts has commented to the inquiry that:

[5] See paragraph 21 above.
[6] SI 1981/1654.
[7] SI 1994/1516.
[8] Council Directive 79/267/EEC of 5 March 1979.

> "At the time ELAS was allowed use of an implicit item, such use was available largely as a matter of routine, subject to the appointed actuary completing the necessary calculations demonstrating that it was justified. In practical terms, it would be difficult to refuse a properly founded and justified application under section 68 of the [1982 Act] and its use was by no means uncommon."

This sense that the applications were seen as routine is generally borne out by other supervisory staff from around this time. The senior line supervisor who took over responsibility for the Society in 1992 told the inquiry that issuing future profits orders in response to applications:

> "...was very routine unless the company was in trouble in some way... When receiving them [the applications], the DTI checked them on the basis of whether they were all present and correct."

The line supervisor for the Society from 1991 to 1998 was reluctant to characterise the process as routine, but commented that she could not remember an application being denied for any reason other than that it had been made late.

34. In the letter of 4 January 1991 mentioned above, GAD advised DTI that they were satisfied with the calculations and that the order therefore should be issued as requested. The order was forwarded to the Society on 11 January. From this point section 68 orders for future profits were to be routinely applied for and obtained by the Society. However, the Society was not to use the implicit items in their regulatory returns until the returns for 1994.

Ranson's dual roles

35. On 28 March 1991 the Secretary to the Society, Roger Bowley, intimated that Sherlock was to retire from office as chief executive on 30 June and that Ranson, appointed actuary since 1982, was to take his place. GAD was consulted. The Government Actuary, Christopher Daykin, advised on 17 April 1991 that he wished to discourage Ranson from holding both positions, other than on a very temporary basis, and would speak to Ranson if there were difficulties. The Society was informed by DTI on 26 April that it was considered undesirable for the same person to hold both positions, and confirmation was sought of the Society's intentions as regards the position of appointed actuary.

36. Ranson telephoned DTI on 30 April. He said that the Society's 'in-house' actuaries needed a further 12 months or so of senior management experience before assuming the role of appointed actuary. It was preferred that he should remain the appointed actuary for 12-18 months until an in-house replacement was appointed. Bowley wrote to confirm on 2 May 1991. Daykin agreed that the temporary situation could be accepted and Burt informed DTI on 13 May that GAD were content on the basis that it was intended to be for a limited period. DTI replied to the Society on 16 May with formal confirmation that:

> "The Secretary of State has no objection to the proposed appointment subject to the understanding that Mr Ranson will only retain the Appointed Actuary role for a further 12 to 18 months as indicated in your letter."

37. This letter provoked a response from the Society on 31 May protesting that a condition appeared to have been imposed on Ranson's appointment as chief executive. It was argued that if Ranson was 'fit and proper' to be appointed chief executive, that assessment would not be altered if for any unforeseen reason he could not cease to be appointed actuary within the time specified. This was presented as a point of principle for the Society.

38. Pickford became involved in the internal discussions that followed. He had spoken to Ranson at an Institute of Actuaries function on 6 June 1991, and wanted the situation defused. He "took Ranson's point" that a point of principle was involved. A point of principle was indeed involved. In a paper presented to the Institute of Actuaries on 28 November 1988 the then Government Actuary, Sir Edward Johnston, had discussed the undesirability of combining the positions of

chief executive and appointed actuary in the light of the appointed actuary's whistle-blowing duties. He recognised that there were points that could be taken against his views, but felt that the arguments against the combination were strong.

39. However, Pickford prevailed, and the condition was removed by DTI on 17 June 1991. It was understood by officials that the intention remained to replace Ranson as appointed actuary within the period twelve to eighteen months. However, largely because of Pickford's intervention on the basis of his discussions with Ranson, DTI had lost the opportunity to impose effective discipline on the Society in this matter, and never thereafter had the authority required to bring about a change.

1990: A Difficult Year in the Markets

40. On 11 June 1991, shortly before submission of the 1990 returns, Ranson wrote to Pickford. It appears from the letter that during a recent conversation between them at an actuaries' meeting, Pickford had asked about the Society's 1990 valuation and bonus declarations (which had taken place on 13 February 1991). He was told that, as had been mooted as a possibility by Ranson at the 14 November meeting, in response to their difficulties the Society had weakened the liability valuation rate to boost the free assets at the year-end. The change from an interest rate of 8¾% to 10% reduced liabilities and increased the surplus by £557m. In accordance with the new bonus system the Society had allotted a notional 'total growth rate' of 12%, despite a net investment return of minus 10.4%, the first negative return for the Society since 1974. Although granted a future profits implicit item for 1990, the Society had not in fact made use of it, having generated more than enough surplus by the change in valuation assumption.

41. In order to give Pickford a "feel" for the discussion that had led to these decisions, Ranson enclosed with the letter some "confidential" board papers, which he asked to be given "restricted circulation within your department". The letter ended with this plea:

> "I realise, of course, that you cannot forget your supervisory role when reading these papers but I hope that you will be able to accept them as an example of 'steering' a board to acceptable conclusions. I have to hope also that I have not given a hostage to fortune!"

The papers enclosed were the papers to the Board on valuation and bonus declaration from the previous September, November, January and February[9], plus a paper on investment for the March 1991 Board.

42. These papers had disclosed a material change in the presentation of the Society's approach to bonus. They combined a 'return to basics' statement of the benchmarking of reversionary bonus to a deposit rate of interest with a pragmatic and arbitrary restriction of the rate to produce an acceptable result. They repeated the view that, since policyholders were shown how policy values rolled up from year to year at an overall rate of return, it should not matter to what extent the roll-up rate was consolidated by declaration. They disclosed Ranson's view that the primary requirement was that there should be an excess of assets over liabilities at least equal to the minimum guaranteed fund. And they disclosed the 'solution' to the problem in the form of a weakening of the liabilities valuation. They also made extensive reference to the adverse marketing implications of cutting or passing bonus. The president's statement in the published Companies Act accounts had made explicit reference to the actuarial adjustments made in respect of the valuation interest rate. Pickford had been put in possession of critical information that disclosed the Society's precarious position, and the extreme nature of the steps taken to maintain bonus allocation in a year of severe losses. There had also been repetition of the key feature of the new bonus system, that the roll-up of total policy

[9] See chapter 4, paragraphs 45 to 57.

values from year to year reduced or eliminated the relevance of the distinction between reversionary and final bonus.

43. It would appear that Pickford respected Ranson's request not to pass the papers to DTI. In a undated note to Burt about the letter and its contents, Pickford concluded that:

> "I don't think we need to show these to the DTI unless the situation in due course warrants it."

He then said that he would review the papers before the appointed actuaries' meeting on 27 September. On 26 July, not long after the receipt by DTI of the 1990 returns, Pickford wrote to Ranson thanking him for the papers, referring to discussions at the upcoming meeting about issues "in this general area" and assuring him that they would get "an extremely restricted circulation". Pickford has told the inquiry that he recalls that the September meeting was the profession's initiative, in light of the over-distribution occurring at this time, to try and influence companies to start reducing reversionary bonus levels.

44. Within the available documents there appears to be no written account of what Pickford or anyone else at GAD made of the content of these Board papers at the time (although it would seem that they informed his questions at a much later meeting in May 1992[10]). Pickford recalls that the use of the terminal bonus in the way envisaged by Ranson in the September 1990 paper[11] to the Board had been agreed around the passing of the 1st life directive to enable mutuals to have some means of covering the solvency margin. He saw no problem with Ranson's approach to the weakening of the valuation base.

45. Pickford has acknowledged to the inquiry that Ranson's letter placed him in a difficult position vis à vis DTI. He has asserted that the provision of the papers had arisen out of a "private discussion at a professional meeting" rather than any scrutiny or formal request for information. At the time he says he had wanted to ensure that he did not discourage Ranson from providing information in the future, although with hindsight he accepted that he may have been over-influenced by the context in which the papers were provided, and may have taken insufficient account of the interest DTI might have had in the issues discussed in them. He was in error in allowing a private understanding with Ranson to cloud his duties to regulators.

46. In their representations, GAD have told the inquiry that it was established practice for information that was "primarily technical and actuarial in nature and had been provided to GAD" not to be routinely passed to DTI, and that the papers in question revealed nothing of immediate concern as regards the Society's solvency position. GAD also appear to reject my view that the papers disclosed important changes to the Society's bonus system, and in particular that the distinction between reversionary and terminal bonus had been reduced or eliminated by the roll-up of total policy values. I do not accept GAD's view of the papers' contents or their significance, or the basis upon which they were withheld from the regulators. Their views on the PRE implications of the bonus presentation are discussed later.[12]

47. The 1990 scrutiny report was sent to DTI on 20 November 1991. At a page and a half it was typical of the period, but given the concerns existing at the time, it appears totally inadequate. It highlighted the rapid expansion of new business, in particular recurrent single premium business (which had risen by 42% from 1989), the fall in asset values common to the rest of the market, and the sharply reduced RMM cover of 1.77x (down from 4.77x). The report noted that the fall in RMM cover was caused by the fall in asset values, the level of new business and the maintenance of bonus levels. This was partly countered by the decision of the actuary:

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[10] See paragraphs 66 to 70 below.

[11] See chapter 4, paragraph 47.

[12] See paragraph 174 below.

> "... to weaken the valuation basis of the with-profits business. The rates of interest he has used are within the limits laid down in the regulations and could be supported by the yields shown in Form 45 although the margin is small. We are asking a few questions about the valuation basis..."

The questions referred to had been raised in a letter from Burt to Ranson the day before, and included a question about the value of the change in valuation base, and a request for advice on the likely position at the coming year-end.

48. Ranson replied on 22 November. He said that if the Society had used the same valuation basis as in 1989, the reserves would have been £557m higher. He forecast that in 1991 it would be necessary to strengthen the valuation basis explicitly or include an explicit mismatching reserve. He said that it was unlikely that the form 9 position[13] at year-end 1991 would be any stronger than at year-end 1990, and that although firm figures were not then available, more information would be provided in due course. Burt acknowledged Ranson's letter on 25 November, and it was passed to DTI on 23 December, but the substantive reply was sent to Ranson on 31 January 1992 and focussed on an issue about reserving for with-profits bonds.

49. That same day GAD sent DTI a memo headed 'Post Scrutiny Report'. Ranson's answers were said to be satisfactory and GAD promised to be in touch when they knew more about the 1991 year-end position. A response to the questions on the with-profits bond was received from Ranson on 14 February and Burt responded the same day to say that GAD had no further points on the 1990 returns. DTI was told the scrutiny was completed in a memo on 24 February. The steps taken to generate surplus for allocation had caused scarcely a ripple on the smooth seas of regulatory practice.

Discussion of 1990 Scrutiny

50. As I have discussed elsewhere, the 1990 bonus allotment was critical for the Society. Despite a return of –10.4%, its first negative return since 1974, the Board decided to maintain bonuses at 1989 levels. A total growth rate of 12% was announced and aggregate policy values reached 128% of available assets at market value. Accrued terminal bonus now stood at over £1.4 billion. The bonus liability valuation had been weakened by the introduction of a differential of 1¼% between the gross bonus rate assumed for rolling forward bonuses (8¾%) and the interest rate used for discounting back to present values (10%). This made the Society's solvency position appear substantially better than it would have on the approach consistently applied in previous years when the rates had been the same. The technical aspects of the mechanism adopted have been discussed in chapter 6 ('lifting the veil'). Despite the change in valuation basis, the Society's cover for its RMM fell sharply. Without the £557m released by the change in valuation assumptions, it would have failed to meet the regulatory solvency test.

51. Having been concerned about the position of the Society in 1990 (as reflected in the 14 November 1990 meeting and the correspondence which followed), neither GAD nor DTI appears to have sustained this level of interest in the Society during 1991. Indeed concern seems to have centred more on the risk that no bonus might be declared than on the sustainability of the bonus that was declared, and once the prospect of a nil declaration receded, an improvement in 1991 was looked to as the solution. Roberts has told the inquiry that, having expressed concerns to GAD, he felt that he had put them "on notice" and was justified in relying on them to monitor the financial position.

52. The papers which Ranson passed to Pickford disclosed an approach to the 1990 bonus allotment that should have raised serious questions amongst the regulators. Having received them, Pickford appears to have made little of them (save to the extent of his questions at the May 1992 meeting). He did not pass them to DTI. It may be that the mindset, culture and resources of DTI at this time were such

[13] See glossary for explanation of 'form 9'.

that little would have been made of the papers in any event; narrow concentration on regulatory solvency might have precluded an overall assessment of the impact of the policy decisions on the future administration of the with-profits fund, and in particular on the implications for in-force business of over-payment of current maturities and other claims. However, at this stage, Burt's last assessment of policyholders' reasonable expectations had been made with reference to total policy proceeds, and there were clear issues for debate. It is clear that at the very least the papers should have been sent to DTI. Had full and proper attention been given to these Board papers, someone within DTI or GAD ought to have realised that Ranson's use of the terminal bonus (as emphasised again within these papers) was designed effectively to bypass "constraints" imposed by the regulatory system with the effect that, from now at the latest, the current return system of regulation began to be less and less relevant to the realistic financial position of the company.

53. It was clear from the board papers and other sources that Ranson's methodology centred around one version of the 'asset shares' approaches to defining policyholders' interests that were developing. The return system of accounting singularly failed to recognise asset shares methodology, and GAD and DTI therefore felt justified in disregarding it. In his statement Pickford made the following observation:

> "Our remit... was mostly concerned with solvency, rather than bonus declarations (except to the extent that the latter might impinge on the former). Asset share techniques were only just being developed... at this time... We did not monitor a company's bonus smoothing process, therefore, focusing instead on compliance with the regulations, especially on the valuation of liabilities and solvency margins."

At Pickford's level in the GAD hierarchy that approach may have been inevitable: scrutinising policy may have been a matter for more senior officials. But as a result the system as a whole was open to exploitation by un-regulated decisions on bonus mix.

54. In the March 1991 investment paper[14], Ranson had asked the Board as part of his calculations to regard 1989 as a year of balance between policy and asset values. The fact of the matter was that in 1989 there was already an imbalance of some 4% (and 5% on with-profits). As has been discussed earlier, over-distribution did not start in 1990, it was already an existing and ongoing problem that was exacerbated by the 1990 declaration.

55. In the scrutiny report, GAD advised DTI of the actuary's decision to weaken the valuation basis of the with-profits business. GAD stated that the rates of interest used were within the limits laid down in the regulations and could be supported by the yields shown in the return. The questions put to Ranson did not include any relating to the choice of, or justification for, the valuation interest rate used. The sole criterion applied, so far as disclosed, was compatibility with the regulations. The prevalent attitude that has emerged from the statements made to the inquiry is that, as long as the rate remained within the regulations, it was an area best left to the professional judgment of the appointed actuary. One of the senior line supervisors commented to the inquiry that, if GAD stated that a weakening was within the regulations, DTI would not have been concerned. Another told the inquiry that this was largely a technical, actuarial point for GAD to advise on.

56. Among other changes in its publications, at this time the Society introduced a new format of the bonus statement. In the statement for 1989 the main statement of total benefits was that of 'total fund guaranteed' under the policy at pension age. There was a separate statement of the equivalent amount if payment were made at the following 1 April, and the additional amount that would be paid then, on current practice and at current rates:

[14] See chapter 4, paragraphs 64 and 65.

> "If final bonus is included in the policy value on 1 April 1990..."

The notice distinguished the guaranteed benefits from prospective benefits, and selected a hypothetical reference date to illustrate the effect of final bonus. The statement for 1990, issued in April 1991, used a fundamentally different presentation. The guaranteed benefits were brought out as at the 1 April and expressed as 'New guaranteed fund value on 1 April 1991'. To that was added 'final bonus addition on 1 April 1991'. The final accumulated figure on the statement was described as 'total fund value on 1 April 1991'. The terminal bonus was presented as an integral part of the year on year benefits accruing to the policyholder; the accompanying notes stated that the benefits were:

> "... expressed in terms of their present value... A comparison of the fund value on 1 April from year to year will show how the investment is growing."

The notes explained that the amount of final bonus was not guaranteed and that "it may vary as financial conditions alter", and could be less than the amount shown.

57. I have discussed the formulation of the bonus notice in the context of PRE. In the present context it is sufficient to note that no one at GAD or DTI appears to have taken note of the change in format at the time. Neither organisation made it their practice to look at bonus statements. Indeed, the Society's approach to bonuses, which I understand was unique, was not mentioned by the regulators until March 1993 (when there was a brief reference to the complexity of the Society's system[15]) and November 1994 (when it was referred to in the 1993 scrutiny report).

Scrutiny of the 1991 Returns

58. On 12 May 1992 Ranson wrote to Burt enclosing some figures for the 1991 year-end position (as he had undertaken to do in his letter of 22 November) in advance of a meeting between the Society, GAD and DTI on 19 May. The meeting was part of a programme (introduced at the end of 1990) of three-yearly visits by DTI and GAD to companies. This meeting, originally scheduled for March, but postponed to May, was the first visit to the Society under the programme, and, so far as extant records show, the first meeting between GAD and the Society since November 1990. In the absence of the general file relating to Equitable, it is not possible to say when any previous meeting between DTI and the Society may have been, but the senior line supervisor for the Society from 1986 to 1991 has told the inquiry that he had never met anyone from the Society face to face. This state of affairs was explained on this basis:

> "Although we had meetings with companies that wished to discuss specific issues, it was not the practice prior to 1992 to visit companies to gather from them background information not evident from the returns to enable us better to understand them and how they were run. Indeed some companies expressed opposition to the idea. This began gradually to change and by 1992 a pilot programme of visits was undertaken...
>
> ... As ELAS were perceived to be well run and sound there would have been no reasons to seek a meeting."

59. In his letter Ranson provided a summary of the form 9 figures likely to be included in the returns due by the end of June. This showed an excess of available assets of £50m over a RMM of £300m, which would provide RMM cover of only 1.17x. In his letter of November 1991, Ranson had referred to a change in the treatment of expenses:

> "From 1976 to 1989 inclusive the Society held a general reserve which was primarily in respect of the estimated shortfall of future premium loadings to meet future expenses on contractual regular premium contracts effected before 1976. Since 1976 the composition of the Society's business has changed substantially from being mainly contractual premium business to the current

[15] See paragraph 90 below.

position in which recurrent single premium contracts comprise the major part of the business. At the 1990 year-end I came to the conclusion that there was sufficient provision in total reserves for future expenses without the need for a separately identifiable reserve in respect of contractual premium contracts, which had become an unnecessary complication."

As discussed in chapter 2, the Society's premium basis for the earliest retirement annuity contacts had not made provision for expenses, and the reserve had been set up to cover the anticipated deficiency. Ranson intimated to GAD that he was making provision in the total reserves, but did not explain the methodology used.

60. In his letter of May 1992, he explained further:

"During 1991 the Society continued to attract relatively large volumes of new annual premium and single premium business (including additional recurrent single premiums). The total amount of such premiums in 1991 was about £1,400m. Taking account of this fact I decided to strengthen the valuation bases for recurrent single premium policies in order to ensure that there was no immediate release of surplus in respect of 1991 premiums. In effect we put the valuation of 1991 new business back on to the premium basis which has been our traditional approach. That strengthening of the valuation bases increased reserves by about £150m. The general basis is also fairly strong because new business expenses are effectively written off as incurred. They will be recouped as the business matures but there is no accepted method of 'zillmerising' recurrent single premium business, which is about 80% of our business in force."[16]

61. Ranson also pointed out that a decision had been made not to take credit for the future profits implicit item in the form 9 figures. A section 68 order for £300m had been granted in December 1991, but a figure of £650m could have been justified. If one compared the excess of available assets plus full allowance for future profits at the 1990 and 1991 year ends, there was an increase from £580m to £700m. "Although", he acknowledged, "a somewhat artificial measure in some respects, I believe it helps to demonstrate the underlying soundness of the Society's financial position". Ranson underlined the message that he was deliberately not doing all he could to make the figures appear more favourable:

"I regard my prime professional role as ensuring that prudent provision has been made for future liabilities, that the various statutory and non-statutory requirements have been satisfied and that a demonstration of solvency can be achieved. I do not regard it as a priority to show the best possible position in Form 9 even though there is a real possibility of attracting adverse comments from so-called 'financial experts'. This is, of course, comment to which we are all well used."

62. The impression communicated by these letters was that new business expenses were written off immediately, that zillmerising could not be practised, and that the expenses were not recovered until maturity. Burt was concerned that this treatment was over-severe and should be queried. On 14 May, in preparation for the upcoming visit, Burt sent a memo enclosing the Ranson letter to Pickford, which he copied to Roberts and the DTI supervisors. The memo provided a brief comparison of the form 9 position as at 1989, 1990 and 1991 (as then projected in Ranson's letter), which showed a further decline in excess assets for 1991, despite the increase in the market value of assets. In addition to comments on the expenses point, Burt commented on general valuation issues. He said that: "the margins were very thin in 1990, with an average interest rate of 7.12%" and suggested that they clarify the net premium rates used for 1991. He also noted that the promised strengthening of the valuation in 1991 increased reserves by only £150m, according to Ranson's letter, compared to the £557m weakening the previous year. Burt also suggesting raising the issue of Ranson continuing to hold the posts of both appointed actuary and

[16] See chapter 6.

CEO. In the margins of the Burt memo, one of the supervisory team at DTI noted, in addition, that "Paul Burt thinks they have been paying too much in bonuses".

63. The scrutinising actuary also prepared a note on 14 May that set out the strengths and weaknesses of the Society as GAD perceived them. The strengths were good service and low expenses. Bad publicity about commission payments by other offices had made Equitable very attractive. Under weaknesses it listed:

> "... Free assets ratio is low and when 1991 results are published a lot of IFAs will question the strength of Equitable.
>
> 3. Equitable has used up investment reserves quickly in paying very good bonuses.
>
> 4. Mr Ranson says that single premium business will release profits when it matures but with-profit bonds business will probably be surrendered early rather than reach maturity when the interest rates will rise.
>
> 5. Recurrent single premium business is exposed to cancellation as soon as there is adverse publicity about the strength of Equitable.
>
> 6. Mr Ranson's position as Principal Executive and Actuary may create problems because there is nobody to blow the whistle when things go wrong."

64. As the meeting was part of a more general programme of meetings, the agenda, which had been sent by GAD in January in anticipation of a meeting in March, was broad, following a standard format that covered a range of governance, business and financial areas. However, a DTI briefing note for the meeting drew attention to the solvency issues from Burt's memo. It also referred to the idea, floated by Ranson at the previous meeting in November 1990, that the Society might not declare a bonus for that year, but had in fact gone on to declare bonus at the same rate as for 1989.

65. By this time a new senior line supervisor had taken over responsibility for Equitable. The post had been upgraded from senior executive officer to grade 7 and the postholder's responsibilities were supposed to be equally split between supervision and policy work. Because of this it was understood that he had been allotted a group of lower profile, "no problem" companies of which the Society was one. He has commented to the inquiry that when he took over responsibility for Equitable he could not recall any specific concerns.

<u>May 1992 Meeting with the Society</u>

66. The new senior line supervisor did not attend the 19 May meeting. Roberts was accompanied by the line supervisor. Pickford and Burt from GAD attended. And again only Ranson represented the Society. The DTI minutes record that Pickford and Roberts both expressed concern about Ranson holding the posts of appointed actuary and managing director. Ranson responded that he did not perceive any conflict of interest, but if one did arise he would drop one of the jobs. In any event, he was due to retire in 3-4 years time, at which point the roles would be separated. He was considering whether any of the actuaries could take on the role of appointed actuary, but the problem was that, at present, there was nobody to take on this role. Traditionally the Society had found its appointed actuaries in-house, but he assured the regulators that the Society was prepared to look outside.

67. When asked by Pickford whether he saw the valuation regulations as a constraint on investment policies, Ranson replied that in fact they were only an irritant in the sense that the Society had to comply with them:

> "[The Society's] main problem was funding the amount of surplus they needed at the right time".

Ranson stated that 80-85% of the business was single premium with-profits. He set out the breakdown of the 1990 and 1991 bonuses as between GIR, declared and terminal bonus and provided some explanation as to how the overall level was set. When asked by Roberts if they reserved for future terminal bonuses, Ranson

explained that the company knew at all times the terminal bonus for each policy on the books. There was a notional terminal bonus reserve called the investment reserve. Annual statements to policyholders showed the notional accrued terminal bonus figure, but stated it was not guaranteed. Ranson explained that they did not want to build up reserves for future generations. As far as the record goes, Ranson does not appear to have answered Roberts' question. Nor did Roberts ask whether the investment reserve was sufficient to cover future terminal bonuses as intimated to policyholders, or follow the point in any other way. However, Roberts has observed that the implication of Ranson's remarks was that the reserves were adequate.

68. Burt noted that if the value of equities fell, the company would need to cover their solvency margin. Ranson responded to this by saying that they would first look after their members' interests and check there would be enough surplus. Then they would do the solvency tests. Although at the end of 1990 there had been a weakening of the liability valuation, in 1991 the basis had been strengthened (but was well within the regulations). Pickford noted that he liked the Society's philosophy for its policyholders, but felt that its solvency strength was arguable. He if there was an in-built mechanism for reducing the reversionary bonus if needed, Ranson explained that he had three options:

i. non-declaration of bonuses;

ii. implicit items; and

iii. to stop writing new business.

Pickford stated that he would be concerned about the Society's performance if there were dramatic falls in the market. There the matter appears to have rested.

69. The minutes do not record any specific discussion about over-distribution, despite the indications in the briefing material that this was a concern. Roberts' recollection of the position at this time was that the Society "had issues that needed managing". Bonus levels appeared high relative to the assets position; the equity ratio was high; and the Society had a low free asset ratio. There was, however, still room to manoeuvre.

70. Pickford has told the inquiry that although the regulators were very disappointed about the dual role situation:

> "... we had got over the problems of 1990 and [Ranson] was beginning to steer the company away from the weak position then."

As for his own comment about liking the philosophy, he explained that he was making the point that the Society's philosophy (ie that everyone got back a fair share based on what the company had earned for them) "did not fit easily with the new solvency regulations". On the meeting more generally, Pickford said that it had not gone as expected and that he had come away quite angry and frustrated that they had not been able to see and assess any other of the Society's managers.

71. Two days after the meeting, Pickford wrote to Ranson thanking him for the "valuable insights" provided at the meeting, but making the point that it would have been desirable to have met some of the senior management team (which he said was a "prime purpose" of these visits). He ended by saying:

> "Nevertheless, I think we all came away knowing a lot more about the company's approach to mutuality, while reinforcing in our minds the unique position of the Equitable in the UK Life Industry."

This perception of the Society's uniqueness was echoed in a number of the regulators' statements taken by the inquiry. It is unfortunate that appreciation that the Society was unique did not provoke a keener interest in the implications for policyholders.

72. On 28 May Ranson replied enclosing some of the information about the management structure, management company accounts and corporate objectives that he had promised at the meeting to provide. Ranson set out some details of the 'actuarial management' and said:

> "With hindsight, it might have been better to have some junior colleagues present at our meeting, but nothing we discussed would have been unfamiliar to them. I do try to run a very open area."

The regulators and GAD had apparently failed to communicate to Ranson the reasons for their interest.

73. On 15 June 1992, again shortly before the submission of the returns, Ranson wrote again to Burt saying that, since his letter of 12 May, he had changed his mind about the presentation of form 9 for 1991. The reason given for the change was the possibility of adverse comment about the "unnecessarily weak" position revealed in the 12 May figures. He had decided that the amount of mathematical reserves shown contained "margins which are not necessary on the grounds of reasonable prudence" and would be reduced by £140m, achieved primarily by maintaining the same liability valuation basis as for 1990 on general annuity and pensions recurrent single premium business. This increased the excess assets from £50m to nearly £200m (and thereby the cover for the RMM from 1.17x to 1.67x). Burt responded on the 19 June, saying he would save any questions he had until he had studied the returns. These were sent by the Society to the DTI on the 29 June. Ranson's letter reflected a major change of stance on reserving from that intimated on 12 May, and from the forecast of the previous year.

74. While the scrutiny was in progress, advice was submitted on 19 August to the Secretary of State regarding an invitation to lunch received from the Society. It does not appear from the files that GAD had passed to the DTI the revised figures as per Ranson's 15 June letter and the brief was probably prepared on the basis of the earlier figures. Despite the fact that even Ranson thought the situation revealed therein was weak, the briefing note struck a reassuring note:

> "The 1990 Returns showed rapid expansion in new premium income, due partly to the success of the Society's with-profits Bond. [The Society's] solvency margin, whilst well covered, has reduced in recent years mainly due to the falls in the market value of equities."

75. On any view the Society's solvency margin was not well covered, either on the basis of the 1990 returns or on either of the two sets of figures for 1991. Whatever the source or basis of this assessment, Pickford was understandably uncomfortable with it and in a memo to Roberts on 21 August 1992 he stated that in fact ELAS' solvency margin was currently "a cause of some concern", as he had indicated in a July memo to Spencer (not seen by the inquiry) about free asset ratios. Pickford added that "Equitable Life will be one of the first companies we will be talking to in our imminent discussions with appointed actuaries".

76. This decision to include the Society amongst the companies whose appointed actuaries were being singled out for special discussions with GAD, in light of the current market conditions, was communicated to the Society in a letter from Burt on 27 August, along with an agenda:

i. Financial Position (current and projected)

ii. Bonus Policy (method and sustainability)

iii. Investment Policy (return and mix)

iv. Resilience Reserves

77. The meeting was arranged for 15 September. On 10 September Ranson sent some background information to Burt. This information included a number of different projected positions and, more significantly perhaps, it also laid bare the current reality of the excess of aggregate policy values (defined in the letter as

"present values of guaranteed benefits plus final/terminal bonuses at the rates then current") over asset shares as follows:

1989	104%
1990	124%
1991	120%

This was information that would not have been available in the returns. At some stage this letter was passed on to DTI. A copy was located on their file.

78. The meeting was attended by Burt and the scrutinising actuary from GAD, the line supervisor from DTI, and Ranson alone from the Society. Burt's minutes of the meeting recorded, inter alia, that:

i. Ranson had stated that the Society believed in active management of declared bonus rates in the light of falling interest rates. So far no decision had been taken on the rates for 1992.

ii. The negative return in 1990 of minus 11.3% (*sic*) had not yet so far been recovered although the return for 1991 had been 14%.

iii. In Ranson's view the Society incorporated modest guarantees into its contracts and he implied that the liability valuation regulations were too stringent.

iv. GAD's view was that "the society has over-distributed in the last few years, compared with the return on investments. This has eroded the level of free assets available in the society, which are needed to provide for market changes in the value of assets".

79. By the time that Burt wrote up the minutes, he had received a further letter from Ranson dated 17 September, which was copied on to DTI. In this letter were some additional projections for 1992 and 1993. Ranson stated that while the Society was well able to meet its regulatory requirements in those projections, "the implications for bonuses would have to be considered carefully". The letter then said:

> "At our meeting you enquired about the extent to which the Society's minimum statutory reserving basis might be weakened by removing 'unnecessary' margins."

Ranson then went on to discuss a number of such options, including a weakening of the valuation basis on account of zillmerisation and taking credit for implicit profits. Burt discussed these two options in his minutes of the meeting and recorded that Ranson thought the former might release up to £150m, and the latter up to £500m.

80. While Burt's minutes were explicit on the subject of over-distribution, they did not record any explanation of, or comment about the specific figures in the 10 September letter for excess of policy values over asset share. (The line supervisor who attended the meeting for the DTI has acknowledged to the inquiry that the figures would not have meant a great deal to her, that she did not have a firm grasp of the concept of asset share, and that it would have been an area in respect of which she said she would have been reliant upon GAD for advice.) Nor was there any comment in the minutes on the suggested zillmerisation.

81. The senior line supervisor, who did not attend the meeting but received a copy of the minutes, was asked by the inquiry for his reaction to GAD's declaration about over-distribution. He said he had no recollection of this issue being raised with him. As for its significance,

> "It may mean that if Paul Burt was the AA [ie appointed actuary for the Society], he would have distributed less fully. I think that this was a difference in professional opinion and I don't read any great concern in this statement. In any event it was clearly a point GAD was alert to and was monitoring."

It was equally clearly a point that had no significance for the supervisor: the observation characterises the respective positions of the officials accurately at this time. Line supervisors and senior line supervisors were not equipped by qualification or experience to form an independent view on the significance of such issues.

82. The GAD scrutiny report on the 1991 returns was produced on 29 October and was signed by Burt. The report ran to just over three pages and noted, inter alia, that the company continued to expand rapidly. Total premiums received were £1.7 billion (as against £1.3 billion in 1990 and £1 billion in 1989), most of which were single premiums or renewable single premiums on pensions business. Contractual annual premiums accounted now for only £75m. The total available assets were £490m, which gave a cover of 1.67x (down from 1.77x in 1990).

83. It was noted that the Society was one of the companies seen recently in connection with their low cover for the RMM in 1991 and future prospects. There appeared to be "little or no margin" in the valuation rates used in 1991. In order to pay the bonuses declared in 1989 and 1991 the company needed to earn 11¼% per annum. In fact the company earned +3% over the two years instead of the required 23%. This was the main reason why the available assets had reduced and the valuation base had been weakened. A major part of the bonuses had been paid out of this weakening and as a result of transfers from the investment reserve. Despite the low cover for the RMM, the Society still had over 60% of its non-linked funds in equities and property, although from recent discussions it appeared that they were then investing in more gilts.

84. In light of the increase in the company's new business figures in the past few years, Burt wondered whether this had given rise to any significant new business strain.

85. A letter was sent to Ranson the same day asking, amongst other things, for a matching rectangle showing what assets would be hypothecated to the net premium mathematical reserves, and the amount of valuation strain in respect of the additional business written in 1991 and other figures in respect of that business. Ranson replied on 6 November. He did not provide the matching rectangle requested, but set out instead an alternative analysis of the assets hypothecated to the net premium reserve. And the new business figures requested were not readily to hand, so he provided instead an analysis of the financial impact of new business in 1991. He said:

> "The results of that analysis shows that the new business did not produce strain during 1991. This was due mainly to the fact that the valuation bases for recurrent single premium business released monies at outset in a similar way to the release produced by a zillmer adjustment."

Burt acknowledged this letter on 12 November, but it received no substantive response until March 1993[17].

86. Meanwhile the scrutiny report had caused some disquiet at DTI. Roberts commented in manuscript on the report on 4 November:

> "This paints a worrying picture. Over distribution by a company with a (deliberately) short coverage of its RMM and a (continuing) policy of high equity exposure. I think we should ask GAD for a better assessment of the position and of the options available to the company in the event of a significant further downturn in the market (unless we have this already, in which case [I] should like to see it pl[ease])."

To this the senior line supervisor added a more specific question to be asked of the actuaries:

[17] See paragraph 90 below.

> "If the investment yield (dividend + capital) is zero in 92, what would the position of the company be at end 92? How long could it continue with present bonuses in the face of a zero yield?"

These comments do not seem to have been passed on to John Rathbone, who had taken over from Burt as principal actuary, until 14 January 1993, when DTI also enquired whether GAD had received any reply to Burt's post scrutiny letter.

87. Meanwhile, DTI had obtained an Equitable document dated September 1992 entitled 'Financial Strength of Life Offices. Some observations by the Equitable Life Assurance Society'. The document described itself as putting into context what it characterised as:

> "... a growing preoccupation...with the financial strength and solvency ratio of life offices and the implications for future bonuses".

It was in essence a criticism of the concept of free asset ratios as over-simplistic, and it stated:

> "Because of the many factors affecting the level of free assets in the published returns a straightforward comparison of 'free asset ratios' is both meaningless and misleading. An office could, in a real sense, be weaker than another office with a lower ratio."

88. Commenting to the inquiry on this paper and the issues it raised, the senior line supervisor said:

> "As far as solvency was concerned, the DTI and GAD regarded free asset ratios as being too simplistic. A lot depended on business that was being written and other areas, all of which were invisible except to the company and to DTI/GAD.
>
> "... companies with larger free assets are able to sustain high bonuses. However ELAS is the lie to that. ELAS didn't fail because they maintained bonus levels despite a low free asset ratio; they failed because they understated their liabilities."

In my view the cause of the Society's 'failure' was a combination of both factors, and others. The failure to value the annuity guarantee liabilities was one aspect only of the total picture. But the statement underlines the comment made at the outset that failure to reserve for the GARs was the substantial cause of the Society's problems in the eyes of a regulator.

89. By 11 January 1993 the Society had applied for and been granted a section 68 order for a future profits implicit item of £360m.

90. On 3 March GAD commented on Ranson's letter of 6 November and responded to the questions posed by DTI on 14 January. On the letter, the view was that Ranson's response to Burt's post-scrutiny questions seemed satisfactory. The Society's bonus system seemed complex and even more difficult for policyholders to understand than that of most companies, but the official view was that there was nothing "inherently unsound" about it.

91. In response to the DTI comments, the scrutinising actuary drew attention to the "unusual features" of the Society, including that they did not pay commission, had a reputation for one of the lowest cost ratios in the industry, had a very high proportion of with-profits business, and that 80-85% of this business was single or recurrent single premium. This latter feature was seen as a strength by GAD, in that the Society only had to secure the benefits bought by the premiums already paid, but a weakness in the sense that it would hold less free reserves and therefore be more vulnerable to changes in asset values.

92. The scrutinising actuary noted that, in setting the bonus rates, the Society had regard to the gilt yield for the year, which did not seem "entirely consistent" with the bonus system or the asset mix. He continued:

> "It no doubt explains what, in retrospect, was an over distribution for 1990. (It seems possible from the RMM cover ratios that the over distribution followed a period of some under distribution; but without going back into previous history in detail I could not be sure.)... We have written... asking for an estimate of the position at the end of 1992, together with details of their bonus distribution and the rate earned on the fund in 1992."

As for available options, the Society could reduce their declared bonuses:

> "They could do this without substantially reducing payouts... through changes to terminal bonus rates. (However they appear not to have the protection against market falls that most companies have in their TB's, because these do not represent a high proportion of their total payouts.)"

The basis for some of these observations is difficult to understand. The suggestion that before 1990 there had been some years of under-distribution was contradicted by GAD's own earlier assessments, and the information provided by Ranson. As before the suggestion that the Society could alleviate the solvency strain by moving further towards final bonus reflected the view that accruing final bonus values were irrelevant for regulatory purposes.

93. Another option that was said to be available to the Society was to weaken the valuation base or use the section 68 order. The memo concluded:

> "Overall I suspect that Equitable could survive a short-term fall in market levels, even a substantial one, as well as most companies. Their portfolio, however, must leave room for concern, were there to be a prolonged period of depressed share value. Their recent shift towards fixed interest securities will ease the difficulties, although they argue at the expense of the expected ultimate benefit to policyholders."

94. Replying the same day to Ranson, the scrutinising actuary observed that, in view of the timing:

> "There seems little point in asking further questions on the matters relating to the 1991 Returns. However we should be interested in your initial estimate of the actual position at the end of 1992..."

The letter asked for details of the RMM, available assets, the rate earned on the fund and the bonus announcement for 1992. It also gave notice of some figures (principally relating to hypothecation) that GAD would in due course require in respect of 1992.

95. Ranson responded on 9 March with details of the currently estimated form 9 position for year-end 1992. The figures showed available assets of £860m and a cover of 2.42x (compared with £490m and 1.67x for 1991). Ranson explained that the figures followed a strengthening of the liability valuation basis for 1992. GAD were also provided with the investment return rate and a press notice dated 3 March regarding the bonus announcement.

96. Ranson's response was passed to the DTI on 11 March with a memo from the scrutinising actuary closing the scrutiny for 1991. On 23 March the line supervisor forwarded this memo and the Ranson letter to the senior line supervisor with a comment that the Society's solvency position estimated for 1992 looked a lot healthier than the previous year's.

Discussion of the 1991 Scrutiny

97. For 1991 the Society had announced an overall growth rate of 12% (the same as for 1990), which was comprised of the 3½% GIR, 6½% reversionary bonus (cut from the 7½% declared for 1987, 1988, 1989 and 1990) and a 2% final bonus (up from 1% in 1990). The investment return was just over 14% (of which half was investment yield) and part of the cost of the bonuses was met by a call on capital appreciation of £185m.

98. GAD and DTI were aware, from the terms of Ranson's letter of 10 September[18], that aggregate policy values at the year-end represented 120% of the assets (124% for with-profits), which included an accrued final bonus figure of over £1.5 billion. GAD and DTI ought also to have noted from the letter that this excess was an ongoing problem (in that the figures showed an excess in 1989, even before the recent fall in asset prices).

99. The projections in Ranson's letter of 12 May forecast a further decline in cover to 1.17x, and Burt was clearly concerned enough to raise the Society's position with Pickford in his memo of 14 May. The meeting on 19 May was therefore an important opportunity to get what further information was available and to face the Society's problems head on. Regrettably it seems that although some issues were raised with the company, little if anything was resolved. The issue of terminal bonuses having been raised by Roberts, it appears that no request was made (then or at any later date) to see the accruing figures to which Ranson referred. At the very least these figures should have been requested in November, once Ranson made explicit the extent of the policy value excess.

100. The exchanges that did take place reflected once more the GAD view that accrued terminal bonus was irrelevant, not only in relation to reserving, but generally. The senior line supervisor at the time, who was not present at the meeting, has told the inquiry that there would not have been concern that the Society was not reserving for terminal bonuses because they were not required to do so by the regulations. He also said that he didn't think he would have asked a question about reserving for terminal bonuses, and did not think it would have been helpful for DTI to know what the accrued figures were.

101. The documents examined did not reflect any material interest in Ranson's intimation that he intended to apply a weak valuation, by using the same liability interest rates as in 1990. Burt commented in the scrutiny report that there were "little or no margins" in this regard, but he provided no explanation to DTI of what the consequences of using such a rate might be. Neither does there appear to have been any discussion between GAD and DTI about Ranson's change of heart, or the reasons given for it.

102. The concerns expressed by GAD at the September 1992 meeting about over-distribution were essentially the same as those expressed in relation to 1990. The concerns of both GAD and DTI about the inability of the Society to cope with any sustained downturn in the market were the same as those being expressed in 1990. Short of a breach of solvency or a breach of the regulations, it would seem that GAD and DTI viewed their responsibility as extending no further than bringing these problems to the attention of the Society's management.

103. Possibly due to the changes of staff at GAD and the DTI after the 1991 scrutiny report, it appears that the general concern about the Society and the specific questions raised about zillmerisation and the valuation basis were allowed to evaporate. The process was lengthy. The quality of GAD's response to queries was poor, and the letters uninformative. The decision to ask no further questions, but instead to look ahead to the next year, reflected previous practice. But it resulted in failure to obtain a full account of the Society's position.

104. Pickford had recognised at the meeting on 19 May that the Society's approach did not fit very well into the current regulatory regime. The labelling of the Society as unique appears frequently within the regulatory papers, but what is absent is any analysis of the extent to which this might prove a barrier to effective regulation and, if so, what changes to the current regulatory system might be needed. Despite Pickford's recognition of the wider problem, and specific questions being raised about terminal bonuses, the valuation basis and new business strain, none of these issues was effectively dealt with or resolved by GAD or DTI. The scrutiny process for the 1991 returns indicates that, without explicit guidance from GAD, the regulators

[18] See paragraph 77 above.

did not have the depth of knowledge about the Society that would have enabled them to make a more accurate assessment of the Society's financial strength. GAD did not provide detailed explanations of many of the issues raised.

GAD Survey on Bonus Distribution

105. On 9 July 1993 Pickford wrote to all appointed actuaries enclosing a questionnaire about bonus distribution. The letter explained that in light of a growing debate about various methodologies (including the new technique known as 'asset shares') and the fact that no information about the assessment of appropriate bonus rates was available in the DTI returns, such a survey was thought to be appropriate. Pickford has told the inquiry that individual responses were put on the GAD file for each office for use in the next detailed scrutiny and all responses were summarised in a report.

106. The Society responded to the survey on 20 July. Among other information given, the response disclosed the view that the Society's articles of association provided absolute discretion as to bonus allocations. No specific information was given to policyholders on the period or magnitude of smoothing, but it was said that in normal circumstances the smoothing cycle should be about 3-5 years. It was said that no specific information was given to policyholders on the likely frequency of changes to final bonus rates. It described the basic approach to final bonuses as involving a number of steps:

a. An appropriate gross rate of accumulation of total policy values for the year was determined having regard to the relationship between policy values and asset shares to date and projected trends in asset shares on various investment assumptions.

b. Comparison of (i) accumulated policy values rolled up at the gross rate of accumulation and (ii) policy benefits excluding final bonus increased by declared bonus gave the required level of maturity values with and without final bonuses.

c. The relationship between the two provided the scale for the final bonus.

d. Some minor further smoothing of the scale was undertaken to produce a practical scale of rates.

e. The progress of aggregate policy values across the whole portfolio was monitored and provided further input into the smoothing process and the setting of the rate in a) above.

There was no immediate regulatory response to the Society's return to the survey. It is not possible to say what was made of the enigmatic first point, that regard was had to asset shares to date and projected trends in asset shares. Projected trends had either to add to or reduce 'asset shares to date'. The obvious question of the limits within which future gains and losses were taken into account was not asked.

Subordinated Bonds

107. At this time another issue came briefly to the fore. As mentioned in chapter 6 [lifting the veil], the Board of the Society first considered raising subordinated loan capital in 1993. At that stage, interest was focussed on the possibility of raising capital from policyholders on an ongoing basis, such as by issuing five and ten year subordinated redeemable bonds to members, rather than through the market. On 7 July 1993 Ranson wrote to the policy side of insurance division seeking comfort in principle for the issue of up to £100m of redeemable individual bonds. The proposal was not in the event taken any further by the Board. But there was a course of correspondence with regulators about the issue that brought out some background material.

108. In his letter Ranson referred to his role at the Association of British Insurers at the time, and to a recent seminar conducted by Bacon & Woodrow at which 'contributions' from members of mutuals had been discussed. He said that offices

were being inundated with proposals for raising subordinated loan capital. The Society was not short of capital, but Ranson suggested to the department that appropriate subordinated debt could release 'new business strains' and 'strengthen' the form 9 position. He thought the draft prudential note, which was to become PGN 1994/1, covered the possibility of members' loans.

109. Insurance division replied that the draft prudential note had not mentioned subordinated loans by members of mutuals expressly. The note had been drafted to apply to subordinated loans in general. But it was not thought that the proposal posed any fundamental problems. The issue should be referred to the Society's line supervisor. The department needed to think further about subordinated members' accounts. Internally, it appears, DTI acknowledged that there was a certain 'magic' about the scope for adjusting solvency by such devices. A manuscript note referred to the 'Merlin' factor spreading. The question was referred to the line supervisors.

110. Meanwhile Ranson wrote to GAD on 9 September 1993:

> "The Society is not short of capital for its business expansion and I do not feel particularly attracted to paying 1½% or 2% over gilt rate to the normal investment market just to 'strengthen' the balance sheet. There would, however, to my mind be a significant attraction to policyholders in having access to an interest paying deposit type contract – and I would certainly rather give our own members the fatter returns rather than fund managers generally. The ensuing strengthening of the balance sheet would be a useful by product."

He sought initial thoughts on the department's support for a section 68 order.

111. There followed an internal discussion within DTI and between DTI and GAD. On 14 October GAD sent a memo to DTI, which raised some specific issues, and in particular:

i. The importance of ensuring that subordination extended to policyholders' reasonable expectations as to future bonuses and not just guaranteed benefits, and that this should be clearly understood by the depositors;

ii. The impact of conduct of business regulation; and

iii. Some issues about the structure of the contract, with particular emphasis on repayment rights.

GAD wrote to Ranson on the same day saying that the proposal had raised policy issues for DTI, on which GAD had made some observations.

112. The policy side of insurance division counselled that the supervisors should tread carefully on the issue of hybrid capital, unless

> "... they as supervisors were totally convinced that Equitable is so strong that the proposal will be 100% beneficial."

After discussion, the Society was asked on 1 November 1993 to comment on how the issue of the deposits would benefit the security, and the reasonable expectations of members generally. The official view was:

> "Our view is that it would be particularly important that the rights of the depositors should be subordinated to those of the with-profits policyholders in respect of their reasonable expectations to future bonuses, not just their guaranteed benefits, and that this was clearly understood by depositors."

113. Ranson's typically prickly response was brief and did not address the questions asked. Instead he wished to know whether the points raised applied generally to life offices, or were specific to the Society. On 7 December it was confirmed that this was an issue of general application where consent was sought to raise hybrid capital, but that it was particularly relevant to with-profits offices because of the need to take account of policyholders' reasonable expectations. The

proposal was not pursued at that time. The official view was, however, clearly on record. And the Society would return to the issue of subordinated loans in 1996.

First Disclosure of the Annuity Guarantees

114. Meanwhile, on 5 November 1993 Rathbone wrote to Ranson to organise a follow up to their September 1992 visit. The agenda was as follows:

i. Financial Position: the letter asked for any report or plans to be supplied in advance.

ii. Bonus Policy

   a. Methods used to set level of reversionary bonuses

   b. Investment return required to support current rates

   c. Level of bonuses likely to be recommended for 1993

   d. Information about the relationship of current payouts to asset shares and the smoothing period

   e. Clarification of any points arising out of recent survey

iii. Investment Policy

   a. Rates of return

   b. Significant changes in mix or policy

iv. Resilience Reserves and the impact of the new resilience test (issued September 1993)

Total policy values were not on the agenda.

30 November 1993 Meeting

115. The meeting took place on 30 November and was attended by Rathbone and the scrutinising actuary, the line supervisor from DTI and, as before, just Ranson from the Society. Some papers had been provided by Ranson in advance of the meeting and included some recent board papers. The minutes recorded that the declared bonus rate for the end of 1993 would be reduced by at least 1% from the year before (ie from 5% in 1992 to 4% or less for 1993). This would need a 7½% return to support, which was roughly equal to the return on the gilt portfolio. It was hoped that this declared rate would "eliminate the excess of payouts over asset shares which had been a recent feature". It was noted that the Society appeared to be moving to a lower proportion of the total bonus payout being guaranteed, and that the valuation basis would be significantly stronger than at year-end 1992.

116. In the course of discussions about the resilience test, Ranson remarked that the Society's pensions business had a guaranteed annuity rate at about 7%, and said:

> "... but this was not as onerous as it appeared since, because old policies had been given the benefit of more modern features and options, it would be reasonable (in his [Ranson's] view) for the allocation of final bonus to be conditional on the waiving of this guarantee".

Handwritten jottings by the line supervisor on the face of some of the board papers provided[19] suggest that Ranson confirmed that the guarantees were not reserved for, and that Rathbone may have queried whether this was consistent with PRE.

117. In this way, the existence of the annuity guarantees and Ranson's proposed solution were apparently disclosed to both GAD and DTI at this meeting. However it was not followed up and did not receive another mention in the regulatory papers

[19] "Guarantees don't reserve for them", "We have no guarantees that bite. JR: PRE?".

until after the issue had been exposed in 1998. In reference to the GAR issue having been raised at this meeting, Rathbone told the inquiry:

> "In Baird I mention that I was aware of falling interest rates and we did have discussions with with-profits offices at this time (1993) and various issues came out such as GAR as mentioned in this note. This understates the problem that subsequently arose. It does not seem to give the extent of the exposure and the annuity rate of 7% was not worrying as it was the same as the gilt rate at that time which later rose again...
>
> No information was provided in the returns about Equitable's exposure to GAR liabilities and there was no description of the bases that the actuary had used to determine the GAR liability. What they ended up disclosing was a totally inappropriate basis. We would not have thought they would be using such an unsound basis."

Whatever one might make of the mitigation offered, the observations make plain that GAD had uncovered a GAR 'issue' at this stage in 1993.

118. In contrast to Rathbone's comments Pickford, the directing actuary, who was not present at the meeting, told the inquiry when shown the papers:

> "I was astonished to read the 7% figure... I do not believe that I have seen that document before, not least because prior to reading the document, I do not remember having seen the figure of 7% being mentioned anywhere in the context of guaranteed annuity rates...
>
> I am surprised that no-one mentioned the company's problem to me, unless the manner of presentation at the meeting on 30 November suggested there was no problem."

119. However, Allen, Roberts and Spencer have denied that the annuity guarantee issue was presented at the meeting as an issue "requiring further exploration". They have suggested to the inquiry that Ranson's description of the Society's approach, which Allen characterises as a "passing remark", was too garbled and obscure to be regarded as an explanation of the differential terminal bonus policy. Indeed, they have offered the view that whatever the approach described was, it was not the differential terminal bonus policy subsequently adopted. This is as may be, but it does not really answer the question of what was understood by the remark, which was recorded in the note of the meeting, or why it was not considered sufficiently important to require further clarification.

120. GAD have observed to the inquiry that the record of the meeting suggests that the regulators were not given a clear indication of an intention to apply a differential terminal bonus policy, and that the extent of its exposure to annuity guarantees was understated. In any case, GAD were not expected to "give a great deal of emphasis to bonus declaration issues, except in cases where PRE was a source of dispute". The service level agreement did not provide for GAD proactively to pursue bonus policy issues with companies.

121. There was no recorded reference to the quasi-zillmer adjustment for expenses of ½% of fund value of recurrent single premium business in the resilience test.

122. So far as the comment made about moving to a lower proportion of the total bonus payout being guaranteed, both Rathbone and the senior line supervisor (who was not present at the meeting either) commented that, in essence, this was a move of which they would have approved. By 13 December 1993 the Society had applied for and been granted (upon GAD's recommendation) a section 68 order for the year ending 1993 in respect of a future profits implicit items of £420m.

123. In February 1994 another DTI briefing note was prepared for an upcoming meeting between the President of the Board of Trade and the Board of the Society. The note 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."

In the event the Minister was unable to attend and Roger Allen, who had taken over from Roberts in 1993, took his place. On 23 February Allen wrote a brief report of the lunch addressed to the line supervisor. The note concluded as follows:

> "Roy Ranson had not realised it was the DTI rather than GAD which supervised his company. I explained the position and told him that you were his supervisor. He was grateful for this information!"

Ranson's remark appears disingenuous, but however it was meant, it highlighted the division of work, responsibility and expertise as between GAD and DTI. Allen has told the inquiry that he used the remark to encourage the line supervisor to adopt a higher profile with the Society.

Scrutiny of the 1992 Returns

124. The priority rating for the Society's regulatory returns for 1992 had again been 3. The scrutiny report for 1992 was not completed until 28 March 1994, and ran to only two pages. In general the points were favourable: the Society had "again had a successful year overall" and the cover for the RMM had risen to 2.36x (from 1.67x in 1991). The report noted that the bonus reserve valuation method used by the Society was "in aggregate, adequate according to the Regulations" and that there had been some minor strengthening of the valuation basis. The net premium valuation (NPV) appeared to give a stronger figure for RMM cover of about 3.9x, but there were some questions to be asked about the NPV basis, which appeared to be somewhat weak.

125. The report also commented on the predominance of recurrent single premium business, which accounted for all but £80m of nearly £1.9 billion total premiums, as this made the Society difficult to compare with other with-profits companies. Although there had been concern in the past that the Society had over-distributed and weakened its reserves, more recently "matters seem to have been brought under better control". There had been an improvement since December 1991 and it was expected that the returns for 1993 would show further improvement. Reversionary and terminal bonuses were reduced for 1992, and the Society had confirmed that the former were to be reduced again for the year just ended. There was further comment about the Society's low ratio of management expenses to total premium, and it was noted that recent correspondence with the Society had indicated that the latter assessed their liability for pensions mis-selling as negligible; "from our knowledge of the company we would have no reason to doubt this". 'Belief' would have been a more accurate reflection of the reality.

126. The notes of the scrutinising actuary also recorded that there was "nothing to note" in the Society's reply to the July 1993 survey. Neither the scrutiny report nor the notes made any reference to what had been said at the November 1993 meeting about the guaranteed annuity rates and the 7%. The inquiry did not discover any analysis of the survey return.

127. The scrutiny report enclosed a letter sent the same day to Ranson asking for the following:

i. a copy of the most recent bonus announcement and henceforth for this to be provided as a matter of routine;

ii. the amount of any resilience reserve which would be required on the net premium basis and which was not covered by the net premium liabilities;

iii. a preliminary estimate of the 1993 year end position; and

iv. an indication of the quantum of the strengthening of the valuation basis which had been indicated in the papers provided for the November 1993 meeting.

128. Ranson replied on 7 April. In relation to the resilience reserve, he explained that an additional reserve of over £460m would have been required. Although this could be supplied to GAD on a confidential basis, the Society would not publish the figures in the returns because it would impose a far more explicit level of disclosure on the Society than on other offices using the net premium office valuations. He reported that the current estimate of the form 9 position for year-end 1993 would be available assets plus implicit items of £1.7 billion over a required level of just under £460m (which produced a cover of 3.75x). The quantum of strengthening of the valuation basis was a little over £1 billion. Ranson also supplied some papers previously requested. The 1992 returns did not disclose the quasi-zillmer adjustment referred to in the response to the GAD bonus survey, and this was not discussed.

129. GAD duly informed DTI on 19 April that Ranson had given full answers to their questions, with which they were generally satisfied, but enclosing a letter in which a few further matters had been raised. GAD explained that the cover for 1993 should be about 3.75x and that the Board papers supplied by the Society had shown a declared bonus rate which was less than could be justified on the Society's usual approach to the figures. The memo explained that the Board had been warned that further bonus reductions might be needed at the end of 1994. GAD forwarded a further response from Ranson to DTI on 7 June, as a result of which GAD had no further questions and the scrutiny was complete.

Discussion of the 1992 Scrutiny

130. The Society had experienced an average year on the market with an investment return on the with-profits fund of 18.4% (including an income yield of 6.9%). They had announced a total growth rate of 10% (a reduction from the 12% of 1991) which comprised of the 3½% GIR, 5% reversionary bonus and 1½% terminal bonus. Part of the cost of the bonuses was met by a call on capital appreciation of £140m. The residual unallocated return went some way to lessening the excess of aggregate policy values over assets, which reduced from 124% on with-profits at year-end 1991 to 116% at year-end 1992. The accrued final bonus figure now stood at over £1.6 billion. Despite some marginal strengthening in the valuation basis, the interest rate for pensions business remained substantially unchanged at 10% (ie the same weakening as for 1990 and 1991).

131. The position of the Society had improved thereafter. 1993 was known to have been a better year by the time the 1992 survey had been completed. The improved position appears to offer the only explanation of a somewhat superficial approach to regulation. The Society's return to the bonus survey called for analytical review. It was not self-explanatory, and the reference to future trends in asset shares clearly required investigation. The information provided on 15 September 1992 about the excess of policy values over assets added to the 1991 and 1992 positions could not be reconciled with the replies on asset share methodology and the smoothing cycle, except on the basis that the period had not been normal. The nature and extent of the abnormalities required further investigation. None was undertaken.

132. The failure to respond to the information tendered about annuity guarantees and the proposed solution was a serious error. The bonus survey replies showed that no specific information was given to policyholders on the likely frequency of changes to final bonus rates. The Society told officials at the November 1993 meeting that it was intended to move toward a higher proportion of terminal bonus in the total bonus mix. A trend in that direction was first noted by the regulators in September 1987[20]. But there seems to have been no consideration of the wider implications of this shift. Failure to relate the problem of low interest rates and the increase in final bonus at this stage and to explore Ranson's description of the Society's approach, however garbled and obscure, resulted in regulators having no insight into the annuity guarantee issue until it was disclosed publicly in 1998.

[20] See paragraphs 4 to 6 above.

133. By 28 March 1994, when the scrutiny report was delivered to DTI, the Society's Board had, on 22 December, 1993 approved amendments to the bonus declaration of 10 February 1993 to introduce the differential final bonus policy, and on 23 February 1994 had approved the bonus declaration for the 1993 declaration and ongoing rates for 1994. The policy was applied for a period over the winter of 1993-94. Any reasonably diligent enquiry following up the information that was communicated in November 1993 must have elicited information about the resolution on, and implementation of the differential final bonus policy.

134. It appears that DTI did not have sufficient sources of information, internal or external to the Society, to respond to the information that such annuity guarantees existed and were becoming valuable. DTI did not receive a copy of the December Board paper until late 1998 well after the GAR issue had emerged. In evidence to the inquiry the line supervisor involved said that:

> "As a supervisor, all I mainly remember about guarantees is that this area was dealt with on the PIA side of supervision... I remember it as a selling issue, as opposed to a supervisory issue for us."

When asked by what mechanism DTI would have been made aware that guarantees were becoming valuable, she said:

> "This was not an expression we used. Any discussion on whether guarantees were becoming an issue would have come from the GAD scrutinies or from meetings held with the companies. I recall guarantees being a marketing issue rather than a regulatory issue."

Her immediate superior, who was the senior line supervisor from 1992 to 1996, told the inquiry:

> "The DTI would not have been in a position to know, without actuarial advice, when guarantees became valuable. I don't remember the existence of guarantees being an issue that was raised during my time at the DTI."

135. Casual acceptance of the Society's position on guarantees as a selling issue, and not one raising prudential issues, reflects complacency for which there could be no justification on information available to the prudential regulator and GAD.

Scrutiny of the 1993 Returns

136. The Society's priority rating of 3 was retained for another year. Within schedule 4 of the 1993 returns there were notes that revealed the existence of the guaranteed annuity options, the fact that Equitable did not propose to reserve explicitly for them, and the implementation of the differential terminal bonus policy. The relevant notes were:

> "Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1993, or such later date of purchase of benefit as applies, to the date of payment of benefits, the amount of final bonus allotted... is reduced by the amount of any such increase.
>
> Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate to the cash fund value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time benefits are taken to the cash fund value of the benefits before such reduction."

137. Two other entries provided context. On page 8, paragraph 3(xiv) noted that for with-profits pension business:

> "The premiums provide a cash fund at the pension date, to which (for policies issued prior to 1 July 1988) a guaranteed annuity rate is applicable."

Page 58, paragraph 5(g) stated that, in the case of contracts providing the right to effect further policies without medical evidence of health, reserves were held, but:

> "It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described in paragraph 3."

Read together, these comments intimated the existence of the guarantees, the lack of relevant reserves, and the differential terminal bonus policy.

138. The presentation of these notes within the returns was disjointed and opaque. However, the understanding of their terms would have been instructed by the information given at the November 1993 meeting, had that been adequately explored and taken into account[21].

139. Once again the relevant section of the 1993 returns made no reference to the quasi-zillmer adjustment of ½% of recurrent single premium fund value for future expenses recovery.

140. Paragraph 8.2 of the scrutiny report for 1993, produced on 15 November 1994, dealt with changes from the information provided in the previous year. Neither there nor elsewhere did the report mention the changes to schedule 4.

141. Looking back at the 1993 return with the benefit of hindsight, Pickford, the directing actuary, commented to the inquiry:

> "My initial reaction to [the paragraph about the differential terminal bonus policy] was "*so this is where they have hidden it*". ...I found the paragraph difficult to understand even when I knew the kind of thing I was looking for... If one reads it carefully a number of times and knows what it refers to, one can understand it, but I find it difficult phrasing."

Rathbone, who was the principal actuary and worked to Pickford, commented on the relevant passages, also with hindsight:

> "The wording... is not particularly easy to read... I would not have expected them to not reserve for the GAR liability just because they expected to cover the costs by using terminal bonus, but I would have expected them to set out the reserving position for these guarantees in the body of the return... There is no evidence to suggest that this paragraph was picked up at the time as a change from previous returns. I cannot recall whether or not this change was identified at the time although I would have expected it to be referred to in the scrutiny report if it had been."

William Hewitson had no responsibility for the Society at this time, but had cause to look back at the returns during the much later period when he was directing actuary and when giving evidence to the inquiry. He told the inquiry that:

> "The way the 1993 return is worded seems skimpy and sketchy to me and does not give enough information on which to base a conclusion."

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[21] I note that the return was heavily annotated in red ink at some stage and that each of the paragraphs quoted was annotated "New". Each was also at some stage heavily sidelined with pencil. The first paragraph was also marked with "?" and that and the pencil sidelining had been erased as far as possible. As a matter of routine returns were compared with the previous year's returns by a junior in GAD and changes identified. These markings seemed to indicate that the paragraphs were read and identified as significant, or potentially significant, by two separate individuals, and that while the significance of the first paragraph was reduced or eliminated on further consideration, the significance of the second survived scrutiny. However, when presented with the sources as the basis for counsel's view that GAD had tacitly accepted Equitable's reserving practice, GAD witnesses have consistently rejected the suggestion on the basis that the information supplied was limited. Allen, Roberts and Spencer have also said that in their view the "overwhelming probability" is that the sidelining was added to indicate their significance when attention was brought to them after the GAR crisis had broken in 1998. As such it cannot be taken to indicate that their significance was recognised at the time.

142. The scrutiny report on the 1993 returns was written by Andrew Chamberlain, who had taken over as scrutinising actuary for the Society, working to Rathbone. It ran to some 17 pages. This was the first new style scrutiny and contained not only much more information about the company but also sections which highlighted 'Key Features' and 'Action Points'. The new style reports, later formalised in the 1995 agreement between DTI and GAD were a vast improvement in the quantity and quality of information supplied to DTI.

143. The scrutiny form provided for the supply of summary information on the office, including a potted history, an asessment of the office's soundness, business types and trends, expenses control, assets and liabilities, and the supportability of bonus. It identified action points. It provided for summary financial information for the current and previous four years covering regular and single premium income; new business; expenses, distinguishing commission from other expenses; claims history; valuation and solvency, with an analysis of liabilities, among other data.

144. Equitable's 1993 scrutiny noted that the Society had a healthy cover for the RMM of 3.75x; low expenses ratios, comfortably the best ratios in the industry; and continuing growth in new business, mainly pensions. Action points were noted. GAD had requested some further information from the Society, including information about:

i. The use of seemingly high interest rates in the valuation;

ii. The use of mortality rates that looked light;

iii. The basis upon which the expense reserves were determined; and

iv. The amount of the resilience reserve required;

v. Background.

It was commented that the approach to bonuses was somewhat unusual. The Society used the bonus reserve valuation basis, but the results of net premium basis were also shown "with assumptions close to the minimum permitted by the regulations". The Society applied for, but never used, a section 68 order for an implicit future profits item. The appointed actuary and managing director positions were both held by Ranson. It noted problems with the Inland Revenue over the managed annuity. It set out the financial information required by the form.

145. In relation to valuation and solvency, specific points were made, including:

i. The gross premium valuation basis used was not particularly relevant to supervision, but was a distribution tool. The adequacy of the valuation was instead demonstrated by the net premium calculations;

ii. The net premium bases used had a number of apparent weaknesses, but in light of the cover for the RMM "there is little concern as to solvency". It was noted: "If however, the reserves are too thin, it may lead to inappropriate conclusions being drawn by policyholders and prospective policyholders as to the financial strength of the society". Confirmation was therefore being sought of the prudence of certain assumptions made;

iii. The rates of interest used seemed high and further information was being sought;

iv. Some of the mortality tables looked a little optimistic and further information on their justification was being sought;

v. The cover for the RMM of 3.75x (4.6x on the NPV basis) remained "substantial" and gave no cause for concern in itself. The only issues revolved around whether the valuation basis itself was of sufficient strength.

146. On bonus policy the report commented that the Society's system of final bonuses was somewhat unusual in that it was not reversionary, but had a lot of

features in common with reversionary bonuses, ie it was declared in a similar way as a percentage of benefit, and the amount paid at the end was the sum of the annual "declarations", subject to the proviso that a previously granted statement could be withdrawn. The report noted that the Society followed a policy of full distribution, and commented that:

> "The policy is to link declared reversionary bonus rates to the redemption yields on fixed interest stock. This has produced a series of reductions in recent years as yields have fallen, but the system of final bonus effectively balances this in total returns. Policyholders' reasonable expectations are therefore influenced downwards in line with yields."

This comment was particularly opaque, apparently relating PRE to reversionary bonus, but relating that to total returns that were maintained by final bonus. It is difficult to penetrate the intention, given the recognition that total bonus had features in common with reversionary bonuses.

147. On the same date as he submitted the scrutiny, Chamberlain wrote to Ranson raising the queries referred to, including the interest rates in the valuation (a matching rectangle was again requested), mortality tables and the amount of reserves required in the net premium valuation on a number of scenarios. No question was asked about annuity guarantees.

148. Ranson replied on 22 November providing some figures about the matching of hypothecated assets and the interest rate used, accepting that a slight strengthening of a mortality table might now be appropriate and would be reviewed for the 1994 returns and giving the requested resilience reserve figures. Chamberlain responded the next day and raised a question about Ranson's use of an average valuation interest rate. Before a reply was received the correspondence was copied to the DTI along with a table showing the revised cover figure on the NPV basis (3.9x). Chamberlain concluded:

> "In view of the nature of the net premium valuation for this company... and the undoubted adequacy of the reserves in aggregate, we are satisfied with the replies received... We regard this scrutiny as complete."

149. Ranson replied to Chamberlain on 30 November and sought to debate the GAD stance on the valuation interest rate. While he conceded that he could see how a "literal reading" of the particular regulation could lead to Chamberlain's position, he thought that on the basis of a more holistic interpretation it was reasonable to permit use of an average.

150. Chamberlain responded on 2 December disputing Ranson's interpretation of the regulations and insisting that he should comply with their request in the 1994 return. Ranson replied on 7 December saying that he did not want to prolong the correspondence unduly, but promising to give further consideration to the matters raised. In his statement to the inquiry Chamberlain said the following about his query on the interest rate:

> "At this time, the method of regulation was different to that of today. We were not prospectively analysing valuation but reviewing the return to see if the company was insolvent at the time. If you removed any weakness in the basis and it was still solvent, then the company was allowed to continue: pass the test today and you could go on tomorrow. The resilience test and the mismatch test... are both tests of the future solvency but only based on immediate events and not developing trends or issues...
>
> I wrote on 23rd November 1994 ... to explain why I thought that the answer was wrong since the averaging of rates is not allowed under the regulations ... This was a matter of law not of actuarial judgment and if he had not given in it would have been escalated with the DTI enforcing it by refusing to accept Equitable's returns as correct."

In the event, the issue having been identified, the 1993 scrutiny was closed, and the problem was left for Ranson to address in the 1994 returns.

December 1994 Meeting

151. In the meanwhile DTI were preparing for a meeting scheduled for 9 December. This was to be the second in the rolling programme of visits (the first having taken place in May 1992). An internal memorandum of 29 November noted that the reserves were adequate. Commenting that he was not certain that GAD had followed up their query about the prudence of certain of the assumptions used in the valuation basis, the senior line supervisor said:

> "The point which concerns me a little is that as from the 1994 returns, it's not sufficient for the actuarial liabilities to be estimated prudently. Each of the assumptions which go into the actuarial calculation has itself to be prudent. Equitable need to be alive to this."

GAD suggested that this question be raised at the meeting.

152. A briefing note dated 6 December prepared for the meeting listed recent issues. These included applications for certain section 68 orders in relation to investment holdings, the Society's classification of critical illness and major medical expenses plans, and Ranson's dual role. The list of concerns was narrowly focused. It omitted reference to either the annuity guarantee or the bonus issue.

153. The 9 December meeting was attended by the two line supervisors from DTI, Rathbone and Chamberlain from GAD, and Ranson and David Thomas (described in the minutes as the investment manager) from the Society. This was the first meeting with the Society for the senior line supervisor and the first meeting attended by anyone from the Society other than Ranson. It would appear that, despite the appearance of Thomas, Rathbone was still concerned about the absence of a more representative sample from the company, because a few days after the meeting Ranson wrote offering DTI a visit to the Aylesbury office remarking:

> "You can then meet some other colleagues which would help demonstrate that there are other people here besides myself, just to pick up John Rathbone's comments!"

The minutes of the meeting noted, among other points, that the Society had achieved enormous growth in business between 1984 and 1993 (single premiums having risen from £45m to over £1 billion). Ranson announced that he would continue with his dual role until the spring of 1996:

> "There had been about five years of vigorous change – in future there would be a consolidation period. He had run the company as an autocracy (!) – after his departure there would be more of a team effort."

154. Under the heading 'Bonus Philosophy', the minutes recorded that the declared rate for 1994 would remain at 4%. Rathbone asked about their smoothing technique and Ranson explained that they looked to the deemed gilt return for the year. Any balance after the roll up of 3½% and reversionary bonus of 4% was the non-guaranteed bonus. Ranson said that he would be asking the Board to deem an "intrinsic value" of 10% for 1994. He commented that in 1993 the Society had distributed only 13% as against an available 17%. "They took a broad approach to smoothing", the minutes noted. Ranson also said it was expected that the Society would "overshoot" in 1994 and, although DTI might be worried, the Society were not.

155. Although not recorded in the typed minutes, the line supervisor's handwritten notes recorded the following question by Rathbone and answer at this point:

> "Rath – do you raise people's expectations? No."

The minutes and the notes then recorded Ranson saying that the Society did not do a market adjustment, which Ranson viewed as a "young actuary's idea", and

Chamberlain commenting that "it looked like over-distribution compared with market values".

156. On the subject of solvency, Ranson stated that he was not concerned how small the free assets got. It was open to the Society to use an implicit item, or not declare a bonus if need be. The Society had not shown the implicit items on their returns, as this would make them look weak, although if the Society's free asset ratio became negative, he would use the implicit item that he applied for each year. He also said that the Society did not go in for reinsurance, and that the DTI/GAD guidelines on resilience testing were followed, but not slavishly, and that the Society always went for the weakest possible valuation.

157. In respect of the discussion about bonuses at this meeting, Chamberlain has told the inquiry that:

> "Ranson would say nothing if not forced to, but it was obvious that non-guaranteed liabilities were backed in part by 'aspirational assets' such as computer systems and future savings. In fact, Ranson boasted that this was part of Equitable's distribution calculation. There was no regulatory consequence to their bonus mechanism, but it did show how reliant they were on recovering money in future to save having to recoup from the current book... I was aware that this so called "over-distribution" was not wrong under regulatory law... Equitable was widely praised for their full distribution policy, for example by the Consumer Association. However, if anything were to go wrong there would be only one recourse, which would be to recover additional funds from policyholders. We did have an issue here in that Equitable trumpeted this distribution policy and this could establish higher PRE... I suspected that by adding the values of all admissible and inadmissible assets and comparing these with terminal bonus inclusive liabilities there was a possible excess over assets in some years resulting from the smoothing policy..."

158. On 13 December the line supervisor wrote to Ranson thanking him for his hospitality. He noted that DTI had not yet received any application for a future profits implicit item for the year ending 1994, but saying that if Ranson wanted one could he please submit the figures before the year-end. Ranson did so two days later, submitting an application for £500m. On 20 December he followed up with a letter to Rathbone on 'Future Profits Implicit Item – Interaction with the Resilience Test', in which he explained that, having applied for a section 68 order to bring future profits implicit item onto their form 9 position, he felt that the time was now right to make use of the orders applied for when considering the resilience test.

159. Although the new scrutinising actuary, Andrew Chamberlain, queried the basis used by the Society for calculating the full value, GAD approved the application, which was granted on 29 December. The difference about this application was that, despite Ranson's comments at the December meeting about not wishing to look weak, it turned out be the first order actually used by the Society. Ranson notified DTI of his intention to do so in March 1995.

160. As of May 1995 the implied annuity rates in the Society's annuity guarantees overtook, and did not again go below, current annuity rates.

Discussion of the 1993 Scrutiny

161. The Society had experienced an exceptional year on the market with an investment return on the with-profits fund of 28.8% (including an income yield of 6%). The Society had announced a total growth rate of 13% (an increase from the 10% of 1992), which was comprised of the 3½% GIR, 4% reversionary bonus and 5½% terminal bonus. Part of the cost of the bonuses was met by a call on capital appreciation of £1.2 billion. The residual unallocated return went some way to lessening the excess of aggregate policy values over assets, which reduced from 116% on with-profits at year-end 1992 to 102% at year-end 1993. The accrued final bonus figure now stood at over £2 billion. The interest rate used in the liability

valuation was 7¼%, down from the 10% used in 1990, 1991 and 1992. This change resulted in a strengthening of the liability valuation basis, which increased liabilities and decreased surplus by over £1 billion. The regulatory cover factor had risen from 2.37x in 1992 to 3.75x in 1993.

162. As disclosed in the regulatory returns, 1993 represented a year of further improvement for the Society and a year in which the new improved scrutiny procedures provided regulators with much fuller information about the company. However, this scrutiny and the December 1994 meeting represent a three-fold missed opportunity.

Annuity guarantees

163. The regulators failed to respond to the existence of the guaranteed annuity rates and the Society's proposed solution, as revealed (albeit opaquely) in the returns and at the November 1993 meeting. Nowhere in the scrutiny report for 1993 was anything said about the annuity guarantee issue. Chamberlain had not been present at the November 1993 meeting, having only joined GAD in September 1994, but Rathbone had been present. He has told the inquiry that, as principal actuary, he would have reviewed the scrutiny report before it went out, and as Chamberlain was new in post would probably have looked in more detail at the returns themselves. There has been no explanation of the failure of those involved to note the importance of this issue.

Terminal bonus

164. The regulators also missed an opportunity to make a full assessment of the Society's increased use and presentation of final bonus. The 1993 scrutiny report appears to be the first occasion on which the unusual aspects of the Society's bonus system, and especially its final bonus, were fleshed out and discussed by the regulators. The new format of bonus statements had appeared in April 1991. The fact that their bonus system was complex had been mentioned in March 1993[22], but without any real explanation of the reasons why, or the respects in which, it differed from general industry practice. Questions were asked at the meeting that focused on the intended allocation, the undefined smoothing policy of the Society, and the risk of 'overshooting' in 1994. Rathbone raised the question of policyholders' reasonable expectations, but Ranson's categorical denial that policyholders' reasonable expectations were raised appears to have been the end of the issue. Allen has explained that this did not represent any pusillanimity on DTI's behalf, but a judgement that in the time available other issues took priority.

165. Officials had been made aware on a number of occasions that the Society intended to make a proportionately higher use of terminal bonuses (the most recent occasion being the November 1993 meeting). The information available to them should have alerted them to the way in which bonus policy was being presented to policyholders. The bonus rates for the year ending 1993 put the balance between reversionary and terminal bonus at 42/58 (a reversionary bonus of 4% and a terminal bonus of 5½%). Between 1985 and 1987 the balance had been 94/6 or below. Between 1988 and 1992 the balance had been somewhere between 88/12 (1990) and 45/54 (1989). The drift in bonus mix towards terminal bonus was accelerating.

166. In 1993 the percentage of benefits paid by way of terminal bonus was at its highest to that date. When asked by the inquiry for a reaction to Chamberlain's explanation in the report of the Society's final bonus and a view on the action, if any, that should have been taken, the line supervisor surmised that, absent any area of concern in key features or action points, GAD were content. If GAD did not raise it as an area of concern, DTI would not be concerned. These were technical issues.

[22] Again, see paragraph 90 above.

167. I deal separately with the issue of PRE and the scope for regulatory action[23]. At this stage, I note that the senior line supervisor acknowledged that the Society's treatment of final bonus was unusual, but that there was an "explicit health warning" that terminal bonus was not guaranteed. Roberts had views on policyholders' reasonable expectations and the Society's forms that included the comment that:

> "Just because there is a long period of bonus statement showing increases in terminal bonus it does not mean that expectation would develop in a reasonable mind that this would necessarily continue... In the case of ELAS some policyholders appear either to have misunderstood the bonus statement, or thought it was something else."

168. His successor, Allen said:

> "ELAS' bonus statements were unusual... Most life offices do not give any advance indication of the likely size of terminal bonus,... it is ironic that ELAS was so transparent and that it has caused them so many problems... The wording on [the] bonus statements said that it was not guaranteed, but it seems that they did not get this over clearly to policyholders...
>
> "The fact that a company has always paid a terminal bonus in the past would create an expectation that, all things being equal, it would continue to pay one. Nevertheless, the bottom line is the fact that the terminal bonus is not guaranteed."

169. From the GAD perspective, Rathbone told the inquiry:

> "Equitable may have created unreasonable expectations by the way in which they published and allocated the rate of return that included a discretionary bonus.
>
> We were aware that the overall rates of return were qualified on the bonus notices as not being guaranteed and for information only so if that qualification was read no reasonable expectation was created and no commitment had been made. It is possible that policyholders might have had unreasonable expectations."

Although GAD acknowledge in their representations to the inquiry that the practice did raise PRE issues, it remains their view that the implication of the notes stating that terminal bonus was not guaranteed meant that there could not have been a reasonable expectation of payment of such a bonus. This was a practical demonstration of a narrow, and in my view erroneous, understanding of what the statutory framework provided for the benefit of with-profits policyholders. More generally, GAD observed that:

> "It was generally accepted in the life insurance market that past levels of terminal bonus did not create reasonable expectations for the future, as they would be entirely dependent on market conditions, subject to a degree of smoothing, which varied considerably from company to company."

The generalisation may or may not have been a valid reflection of industry views. But Equitable's practice was anomalous, and required independent analysis for a valid view to be taken. I accept that policyholders would not have reasonable expectations of receiving terminal bonus based on the precise sum intimated in bonus notices, and that their reasonable expectations would be conditioned by market conditions and by the expectation of smoothing. But they appear to me to have been entitled reasonably to expect that any difference should reflect market conditions, modified by the application of the Society's smoothing policy. Accordingly, I do not accept the implication of GAD's representations that no PRE was created (or that there was no change to the "usual PRE attaching to terminal bonus" in their terms) by virtue of the presentation.

[23] See paragraph 174 below.

170. Whatever the niceties of GAD's position, it seems to me that regulatory policy and practice were concentrated on contractual benefits, and, from the comments quoted above, that that approach applied to policyholders' reasonable expectations as well as the computation of liabilities. Even if that did not stem from a fundamental error of statutory interpretation, it nevertheless indicates that official attitudes reflected a general lack of focus on relevant issues in respect of PRE. For immediate purposes it is enough to note that the view conditioned the approach of GAD and DTI alike to the supervision of Equitable. A dramatic shift from reversionary to final bonus reduced the scope for effective regulation of total bonus through the returns system. Officials should have been alerted to the need to ensure careful monitoring of the Society's practice. The greater the drift from reversionary to final bonus, the less relevant the returns became to regulation of the total business of the office, and the greater became the need to consider a more particular or more intrusive form of regulation.

Over-distribution

171. The guaranteed annuity rates and the final bonus issue were not picked up or discussed at the December 1994 meeting. This meeting also presented a third missed opportunity, namely Chamberlain's concerns about over-distribution. Chamberlain suggested at this meeting that it looked like there was an over-distribution compared with market values. He may have been looking forward to the end of 1994, rather than at the end of 1993. But the general point was identified.

172. Those who were responsible for regulating ELAS appear to have viewed over-distribution as a problem isolated to each year rather than a cumulative issue. There had been general concern about over-distribution in 1991 and explicit concern about the Society over-distributing in the memo of 14 May 1992 and at the meeting with Ranson on 15 September 1992 (following the 10 September letter from Ranson which set out the extent of the excess position as at 1989, 1990 and 1991). The scrutinising actuary's March 1993 note (about the year end 1991) and March 1994 scrutiny report (for the year ending 1992) had presented DTI with the impression that it was a problem that had been overcome. Yet by 9 December 1994, on any view, the problem had returned. Commenting on Chamberlain's comment about over-distribution at that meeting, the senior line supervisor told the inquiry:

> "Despite this being another comment about over-distribution, this would not of itself have been of great significance. We would not be unduly concerned at "over distribution" if it happened for a year or two as this is what was expected given fluctuating asset values. There were sufficient layers of prudence in the assessment of liabilities to allow for this. If GAD thought there was any imprudence over such "over distribution", they would certainly make their views known to us."

The comment was focused on fund value. The implications for different generations of policyholders, and in particular the implications for current maturities as against continuing business were not assessed.

173. Each year from 1987, at the latest, to 2000 aggregate policy values exceeded available assets at market value (albeit by varying amounts and percentages)[24] on a fund basis. The figures for the post-1991 period that would have demonstrated this were never in the possession of the regulators and, until the end of 1997, never requested by them. Aggregate policy values appear to have been a matter of casual interest rather than serious concern. Just as on previous occasions when concerns about over-distribution were raised, save for noting them, no salient further information was sought and no action was taken. One of the main reasons for this appears have been the view that so long as the company could cover its RMM and did not contravene the regulations, there could and would be no real interference from GAD or DTI.

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[24] See chapter 6.

174. In this regard, I do not accept GAD's view that intervention on PRE grounds would have depended on an interpretation that PRE in this case involved an expectation that terminal bonus could not reduce. It would have depended on a view that PRE required terminal bonus only to reduce in line with underlying market movements, in line with the bonus literature, and not as a result of some prior weakness in the fund.

175. In a letter marked 'draft' from Pickford to Ranson in April 1995 (in response to a letter from Ranson in which he had complained that having conducted the bonus survey in 1993 and thereby been in danger of straying into areas of purely commercial concern, GAD had decided to take no action), the following view was expressed:

> "On the point central to your letter, I explained that the grounds for intervention available to the Secretary of State are prescribed in the ICA 1982, as amended, and if higher bonuses are awarded than have been earned, this is principally a matter of commercial judgement provided the reasonable expectations of the other policyholders are not affected."

There is no evidence that there was any substantial investigation of the implications for the reasonable expectations of other policyholders of over-payment, as distinct from over-allocation of bonus. Albeit that 1993 represented the period of least excess between 1989 and 2000, the situation for the year to come was to be a very different story.

A Further Downturn in the Markets

176. On 30 June 1995 DTI received the Society's 1994 regulatory returns. Once again the Society's priority rating of 3 was retained.

177. On 5 November 1995 an article appeared in a Sunday newspaper which reported that Equitable had a low free asset ratio and suggested that independent financial advisers were not recommending the Society's products because it kept its financial strength a secret. The article reported that a spokesman for the Society had responded by saying:

> "The leading credit expert Standard & Poors gives us a 'Double A excellent' rating. We are one of the strongest firms in the industry with almost 500,000 policyholders. No-one is growing as fast."

The Society had supplied a copy of their press release about the rating to GAD and DTI at the meeting in December 1994. On 6 November 1995 DTI received a telephone call from a policyholder who wanted to know what they were going to do about the poor financial position of Equitable as reported in the press article. An internal note dated 8 November drew the article to the attention of the senior line supervisor. It noted that:

> "... EL has a different way of calculating their reserves than most [companies] but surely their financial strength <u>can</u> 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?"

A similar note was sent to GAD. Regulators' reliance on Standard & Poor's rating of the Society and the suggestion that it must have been based on the returns are surprising.

178. In the 1994 return the Society disclosed that:

> "For recurrent single premium business the valuation rates of interest shown in Form 55 are net of a ½% interest rate reduction as a provision for future expenses."

This comment about future expenses could have been compared with information first disclosed in Ranson's letter of 6 November 1992, but omitted from the 1992 and

1993 returns, relating to a zillmer-type adjustment for unrecovered procuration expenses, and might have alerted regulators and GAD to the need to investigate the treatment of expenses generally. There is no evidence of any significant response to the disclosure.

179. The GAD scrutiny report was completed on 23 January 1996 and ran to some 20 pages. The 'key features' section reported the first use of the future profits implicit item; the almost exclusive reliance on recurrent single premium pensions business; low expenses; and the practice of reserving on the weakest basis possible in order to maximise the free asset ratio. The free asset ratio had fallen in 1994. Action points noted were related to mortality bases and the interest rates used in the valuation. GAD had also requested an updated version of the with-profits guide. Background features to which GAD drew attention included comments that:

i. The use of the implicit item was not necessary for statutory purposes and formed part of the excess assets. An order for £500m had been granted for 1995; and

ii. The appointed actuary and managing director positions were both held by Ranson who should retire within a few years, "although it is dangerous to speculate when!"

180. Tables of regular premium new business income and total single premium new business income for 1990-1994 were provided. It was noted that the business results were once again strong but that there would have been a material new business strain in 1994 due to the declining market value of assets. The annual report on the industry "showed Equitable as one of the success stories of 1994", ranking first in pensions business. Expenses ratios had seen a 6% reduction in 1994 and the report commented that expenses had now reached "astonishingly low levels".

181. In respect of valuation and solvency, the report said:

> "It was known from the December 1994 visit that the appointed actuary had decided that ELAS' interests were best served by using a weak valuation basis to show as strong a free asset position as possible, hence the basis used was at the limits of the regulations.
>
> This requires us to exercise particular vigilance in ensuring that users of the returns are not misled. Additionally, the Equitable does have a full distribution policy. Although one should not, perhaps, be critical of this per se, it does mean that the Society is more vulnerable than many to adverse conditions. The low free asset ratio means that there is comparatively little to spare if the reserves do prove inadequate."

However, it was noted that there were some hidden strengths to the valuation, particularly in the treatment of recurrent single premiums. On mortality, it was reported that:

> "The table used for UK annuities was well in excess of recent industry experience and whilst Ranson had claimed he could justify this at the year end 1993, GAD would be pressing him about this "quite vigorously" for 1994."

Comparing the interest rates used in the valuation with a table setting out the yield on assets, the report said:

> "... it is far from clear how this asset yield pattern will allow such a high rate of interest for the with profits business if the non-profit business takes the highest yielding assets to support its valuation rate. We are therefore seeking a thorough matching rectangle in the format proposed under the new Accounts and Statements regulations."

Equitable were to be asked yet again to provide the figure for the difference between the net premium and the gross premium results in its resilience reserves.

182. The Society's RMM was 2.36x (reduced from 3.75x in 1993). It was said that the cover for the RMM "may not be huge but it is adequate, provided the Appointed Actuary can satisfactorily defend his basis from the questions we have raised". In respect of bonuses, the relevant part of the narrative of the Society's system of bonuses was repeated verbatim from the 1993 scrutiny and the tables of figures were updated for 1994. This showed an actual return of minus 4.2% as against an allocation of 10%. On compliance it was said:

> "Although the Equitable take a highly esoteric line on a number of issues, and are inclined to argue their case rather longer than most, they have a culture which would not permit the continuation of a compliance breach."

It seemed unlikely to GAD that the Society could believe or acknowledge that any of their sales force could have been responsible for any mis-selling. There was no explicit provision for mis-selling. But it was understood that £50m had been set aside by an "over-estimation" of the liabilities.

183. In response to the comments recorded about the weakness of the valuation base and the scope for policyholders to be misled, the senior line supervisor at DTI told the inquiry:

> "I would think that this is the AA concluding that instead of eight "layers" of prudence (for example) he could manage with only four. In general terms there are a number of layers of prudence in assessing whether a company's assets are sufficient to meet their liabilities. The first layer of prudence is the RMM... Then the liabilities are calculated not on the best estimate but on a very cautious basis... Over and above that, there were a number of parameters and one had to be prudent in relation to each one of them. After this GAD then added further levels of prudence by requiring reserves on a non-statutory basis to provide for a down side on assets (e.g. resilience reserves)... Finally there was the ability of With-Profits companies to make adjustments to their bonus policy... All those taken together amounted to many layers of prudence, therefore the fact that any one deteriorated would not necessarily have been a particular concern. Looking back on it if one had wanted to design a system as opaque as possible, this system was it. We relied upon the professional advice of GAD to help us see through the opacity and see how much prudence there was on any particular set of assumptions. ...
>
> This commentary was consistent with the picture we had had of ELAS for many years."

Allen has observed that these comments represent a general description of how prudence was built into a life company's valuation, and as such reflected a proper application of the general approach to supervision. I accept that to be the case. What is not apparent is how, if at all, this view informed DTI's approach to the regulation of the Society. The concern must be that too much reliance was placed on Equitable's procedures and systems without full objective analysis of the validity of the assumptions on which the valuation was based.

184. On the day the scrutiny report was completed Chamberlain wrote to Ranson asking for a copy of the latest with-profits guide, a matching rectangle to support the rates of interest used in the alternative net premium valuations shown, and in light of the optimistic mortality table used for most general annuities, any investigations undertaken to support this choice. He said:

> "Could you also please indicate how you feel the future improvement in annuitant mortality is catered for in this choice of basis, and what margins you believe are included for adverse deviations?"

He also asked what increase in reserves would be required on the net premium valuation basis if explicit provision were made for a specific resilience test.

185. Ranson responded on 21 February 1996. The with-profits guide and matching rectangle were enclosed. On mortality he set out his experience, but ended with the

observations that the basis would be strengthened further for the 1995 return, and that he kept such matters under active review. The figure for the increase in reserves was £170m. The adjustment had been postponed for a year.

186. Chamberlain replied on 5 March thanking Ranson for the information provided and adding a few observations. He also passed the correspondence to DTI, enclosing some updated figures (including a slightly improved cover factor of 2.65x) and concluding:

> "We are now satisfied with the valuation basis. The net premium cover for the required minimum margin is greater than that for the published basis and a priority of 4 could have been justified. The scrutiny is now complete."

187. Ranson wrote again to Chamberlain on 25 March complaining about some of the comments in the 5 March letter about mortality rates.

> "The GAD's right to seek confirmation that Appointed Actuaries have had due regard to relevant factors in determining the choice of basis is undisputable although, I would hope, generally felt to be unnecessary. Your comments appear to imply a rather different approach, whereby the GAD decides what is a professionally satisfactory choice of basis and then sees how close offices come to that. That carries the unfortunate impression that the GAD feel the only people capable of exercising true professional judgement are themselves ... You will probably be aware that I feel very strongly that the future of both the regulatory approach and the actuarial profession depends crucially upon the quality of people holding responsible actuarial positions. I would much prefer to see the GAD/DTI taking a far tougher line on whom they allow to become appointed actuaries rather than adopting an increasingly interventionist approach to overcome the deficiencies of some appointees."

Once again Ranson had responded aggressively to GAD's enquiries.

188. And once again the response was muted. Chamberlain responded on 3 April 1996 pointing out that while GAD did not seek to substitute their own judgement, they were obliged, given the heavy reliance placed upon them by the DTI, to confirm that relevant factors had been taken into account and that conclusions reached were reasonable. He added that no criticism of Ranson's professional judgement had been intended. This correspondence was passed on to DTI.

Discussion of the 1994 Scrutiny

189. In 1994, as in 1990, the Society suffered negative investment return (-4.2%, as compared with +28% in 1993). The Society had announced a total growth rate of 10% (a decrease from the 13% of 1993), which was comprised of the 3½% GIR, 4% reversionary bonus and 2½% terminal bonus. Part of the cost of the bonuses was met by a call on capital appreciation of £790m. The excess of aggregate policy values over assets stood at 120% for the with-profits fund (an increase from the 102% of 1993). The accrued final bonus figure now stood at £2.3 billion. The interest rate used in the liability valuation for recurrent single premium business was changed to 5½%. The gross bonus rate assumed was 4%, and this difference of 1½% effectively meant that the reserves held were less than the face value of the guaranteed fund plus the reversionary bonus.

190. The effect of this (as in 1990) was to improve the company's solvency position over the position that would have obtained if there had been no such discounting. The interest rate change resulted in a weakening of the liability valuation that released a surplus of over £1.2 billion. This was in part used to fund the bonuses and meet the investment loss. The regulatory cover factor had fallen to 2.36x (from 3.75x in 1993) and included credit for an implicit item of £250m (without which the cover would have been 1.86x).

191. The papers prepared for the December 1994 meeting had reflected some concern about the Society in that year; the weakness of the liability valuation, reliance on 'aspirational' assets, vulnerability to shocks, the risk of distribution

policies generating policyholders' reasonable expectations, over-distribution, and the need for particular vigilance in supervision. The issues had not been debated fully or resolved. Both the 1993 scrutiny and the 1994 scrutiny reports had expressed concerns about the possibility that policyholders or readers of the returns might be misled about the financial strength of the Society. The discussion of the changes in the valuation base for 1994 should have added materially to that concern, because their effect was to make the Society's solvency position appear stronger than would have been the case on a consistent application of the valuation assumptions applied in 1993. Similarly the discussion of the mortality assumptions applied in annuity liabilities should have caused concern.

192. Chamberlain's comments about the final bonus system were simply repeated verbatim and so elicited no further interest from DTI. Despite mention of the guarantees and the differential terminal bonus policy again in the returns, and in bonus notices sent to retirement annuity policyholders, this issue was not picked up or explored. The declaration of a growth rate of 10% as against a negative investment return of 4.2% combined with the weakness of the valuation should have caused the regulators to dig deeper into the Society's financial health. Once again, other than to note that the Society was vulnerable, the regulators seemed complacent about its position (reflected in Chamberlain's recommendation that their priority could be reduced to a rating of 4, which meant that there would be no requirement for scrutiny to be completed earlier than within 9 months).

Disclosure of the Differential Terminal Bonus Policy

193. Following the Society's resolution on the differential final bonus policy in December 1993, the bonus declaration for 1994 repeated the policy. The declaration for 1995 contained similar notes. In the statements issued to policyholders in March 1996 the words underlined were removed and those in italics added:

> "The total fund values include amounts of final bonus which are not guaranteed and may vary [up or down]. *In addition where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee*... The fund available at retirement may therefore be less than the total [value] shown, but would not be less than the guaranteed value."

The Society's treatment of the annuity guarantees was public; it had been advertised to policyholders.

Scrutiny of the 1995 returns

194. The Society's regulatory returns for the year ending 1995 were sent to DTI on 28 June 1996 and were assigned a priority rating of 4, in line with the view expressed by Chamberlain in March. A few days before Ranson had made an application for a section 68 order in respect of a future profits implicit item of £600m for 1996. This was subsequently granted, upon the recommendation of GAD, on 11 September 1996. In schedule 4, paragraph 7(b) the appointed actuary again[25] disclosed the quasi-zillmer adjustment of ½% for future expenses on recurrent single premium business.

195. In October 1996 DTI wrote to the Society to arrange the next rolling programme visit (the last having been in December 1994). The main areas to be discussed were:

i. business plans for the next 5 years;

ii. the Society's purchase of a majority interest in Permanent Insurance;

iii. the Society's experience of doing business in other EEA states;

iv. the managed annuity;

[25] See chapter 7.

v. use of genetic information;

vi. liability for pension mis-selling, and

vii. a tour of the paperless office.

The letter also made it plain to Ranson that DTI would expect to meet "appropriate members of [the] team".

196. The scrutiny report produced by GAD on 1 November was 16 pages long. It was prepared by a new scrutinising actuary as Chamberlain had been promoted to principal actuary. The report followed the form of the annex to the 1995 agreement between GAD and DTI. The key features noted included:

i. on the basis of long-term business assets, at £16½ billion Equitable was the seventh largest life company;

ii. the Society published a gross premium bonus reserve valuation and a net premium comparison;

iii. for the second year they had used an implicit profits item; and

iv. in a year when the industry had struggled for new business, the Society achieved record sales.

The key features section also noted that the reserving bases were fairly weak by design in order to maximise the free asset ratio while permitting fair bonus distributions to the current generation of policyholders, and that the RMM was "comfortably covered" at 2.89x (an improvement from the 2.36x in 1994) and the cover without the implicit item of £260m would be 2.44x.

197. Under action points, the report proposed topics for discussion at a projected meeting. These included expense levels, increased investment in non-insurance companies, and the sustainability of the existing contract structures largely based on accumulating funds to which regular bonuses were added. Questions were to be raised as to what scenario tests had been performed as regards falls in asset vales and how it would react to sustained unfavourable market movements. Background factors highlighted included:

i. The Society's determination to provide fair bonuses to policyholders with no deliberate holding back of profits from one generation to the next;

ii. The net premium basis valuation used assumptions close to the minimum permitted by the regulations;

iii. The implicit future profits item was applied to increase excess assets. An order for £500m had been granted for 1995 but only £260m used;

iv. Ranson held both appointed actuary and managing director positions.

198. In accordance with the agreed form, comparative tables were provided of regular premium new business income and single premium new business income for 1991-1995. In relation to valuation and solvency, it was reported that it was known from the December 1994 visit that Ranson had decided that the Society's interests were best served by using a weak valuation basis to show as strong a free asset position as possible, hence the basis used was at the limits of the regulations. Detailed matching data was sought in relation to the 1994 returns and was acceptable. It was noted that the Society tried to provide a fair bonus allocation to each generation of policyholders. The result was that lower free assets were revealed "than might have been expected for such a well thought-of institution". However, it was repeated that there were some hidden strengths to the valuation, particularly in the treatment of recurrent single premiums in respect of which it was assumed that no more premiums would be received. It follows that quasi-zillmerisation had not been identified as an issue.

199. On mortality, the report noted that annuities had been valued on the a(90) tables with a two year down-rating. Following discussion of the previous year it was

said that it would be desirable to keep pressing the Society quite vigorously on this point as longevity improved. The table used for pensions was out of date but close to using the effect of the more recent table with a fair adjustment and so GAD were not minded to press on this.

200. The difference in resilience reserves between the net premium and the gross premium results would be over £400m. There was no reason to doubt the adequacy of this "although managing the distribution of bonuses and consequent growth in guaranteed liabilities in respect of a very substantial portfolio of unitised with profit type business is a potential problem to be monitored".

201. On bonuses, the relevant part of the narrative of the Society's system of bonuses was repeated almost verbatim as for the 1993 and 1994 scrutiny with updated figures for 1995. This showed an actual return of 16.6% as against an allocation of 10% (the same as for 1994). The narrative of distribution policy was altered to read as follows:

> "The Society follows a policy aimed at providing each generation of policyholders with a return that reflects earnings on assets during his or her membership of the fund, whilst avoiding short term fluctuations. Thus, total bonuses are intended to reflect a smoothed total earned rate. Part is allocated in the form of non-cancellable reversionary bonuses and the rest is in the form of final bonus."

On compliance, the scrutiny stated that, although the Society liked to think of itself as beyond reproach, it had recently given ground for concern about mortality assumptions. The scrutinising actuary also said he was unconvinced about the value of its gross premium bonus reserve valuation, and would prefer to see a clearer exposition of its ability to react to possible falls in the value of assets (bearing in mind its exceptionally large exposure to unitised with-profit type liabilities).

November 1996 Meeting

202. On 5 November DTI wrote to Ranson and added GAD's three 'action points' to the agenda for the upcoming meeting. On 7 November GAD wrote to Ranson with one post scrutiny query about the gross redemption yield. The third rolling programme visit to the Society took place on 8 November 1996 and was attended by two line supervisors from DTI, the principal and scrutinising actuaries from GAD. the Society was represented by Ranson, Bowley and another senior actuary.

203. The minutes recorded that the scrutinising actuary asked if the Society built up a terminal bonus reserve. Ranson said no and described the terminal bonuses as "instantaneous". When the scrutinising actuary observed that GAD were not clear what the Society's bonus declarations said, Ranson explained that the statements showed a build-up of guaranteed benefits and then also showed the non-guaranteed benefits. The scrutinising actuary then noted that the Society had to be very careful about their bonus statements to ensure that customers were not misled about the benefits. There appears to have been no follow-up on this point, as the notes moved to another issue, the strength of the valuation. Ranson stated that every actuary valued as weakly as possible to make the business look stronger. Ranson also agreed with the suggestion from the scrutinising actuary that the gross premium basis was not really any stronger than a net premium basis, but added that the Society's Board preferred to use the former.

204. It was noted that someone had asked about the orphan estate at the Society's AGM and had been told it was "all paid out". The Society also indicated that they might apply for a section 68 order for a subordinated loan. Finally, the minutes note that Ranson intended to stay on "until all the changes had been consolidated".

Discussion of the 1995 Scrutiny

205. The Society had experienced an average year on the market with an investment return on the with-profits fund of 16.6% (including an income yield of 5.7%). The Society had announced a total growth rate of 10% (the same as for 1994)

which comprised of the 3½% GIR, 4% reversionary bonus and 2½% terminal bonus). Part of the cost of the bonuses was met by a call on capital appreciation of £600m. The residual unallocated return went some way to lessening the excess of aggregate policy values over assets, which reduced from the 120% of 1994 to 112%. The accrued final bonus figure now stood at £2.6 billion. The interest rate used in the liability valuation was reduced by ½% to 5% as against a gross bonus rate assumed of 4%. This change resulted in a strengthening of the liability valuation basis, which increased liabilities and decreased surplus by £462m. The regulatory cover factor had risen to 2.9x (from 2.36x in 1994).

206. The scrutiny report was more favourable than the 1993 and 1994 reports. Large sections of the previous year's report were retained, but the 1995 report omitted the warning of the need for vigilance to ensure readers of the return were not misled. Despite this GAD were clearly exercised at the November 1996 meeting about the terminal bonus issue and how it was being presented to policyholders. Although it does not appear in the minutes, the scrutinising actuary recalled that the issue of the excess of aggregate policy values was mentioned at the November 1996 meeting. He has told the inquiry that at the time the scrutiny report was completed in December 1997:

> "We had long since appreciated the probability that total asset shares exceeded admissible assets. On the 8 November 1996 meeting we were given an indication that the difference was represented by investments in inadmissible assets. Ranson gave some explanation of why and how Equitable did this, but it is not in the notes of the meeting. I do not recall the explanation as being frightening, as it might have been if the difference had been a large figure. The figure for inadmissible assets was not that excessive and according to what we saw at our visit on 8 November 1996 Equitable had an impressive set up at Aylesbury."

Whatever GAD were told about the position as at November 1996, information which would have shown the duration and full extent of the excess seems not to have been requested from the Society. Thus on two important issues (terminal bonus and the excess policy values position) there seems to have been a failure by the regulators to ask for and analyse such further figures or documents as would have enabled them to make a proper assessment of problems that were then being discussed with the company.

The Society Issues Subordinated Debt

207. At this point it is convenient to return to the issue of hybrid capital, first tentatively raised by Ranson in 1993. As mentioned in chapter 6, the Society's Board took up the matter of subordinated loans when an issue by NPI was reported to them in July 1996. In a fuller report to the Board in October, Ranson commented on the way subordinated loans affected the form 9 solvency position by allowing investment that was not off-set by liability. In January 1997 the Board was informed that the Society's form 9 position was becoming tight, and that that could cause restrictions on investment freedom. Approval was given to explore the issue in principle after Ranson recommended it, specifically in his capacity as appointed actuary, underlining the scale of his concern about the Society's solvency position at the time.

208. The proposal was taken forward in June 1997, and the loan issue of £350m was launched on 18 July 1997. A number of technical hurdles had to be overcome to meet listing requirements, and these were duly met. The relevant issue for present purposes relates to regulatory approval.

209. Ranson mentioned the possibility of an application for a section 68 order to use subordinated debt at the meeting with regulators on 8 November 1996. Thereafter, by fax dated 14 March 1997, he intimated an intention to apply for an order for £300m of subordinated debt. He said that the loan was 'essentially for

investment purposes, not to finance developments". He asked whether the Society could avoid setting up a subsidiary. GAD responded to DTI on 24 March, noting that it had been a DTI view that such debt could not be issued from within the long-term fund because it was not possible to achieve the proper degree of subordination, and suggested that the supervisors should consult policy colleagues. The departmental guidance has been discussed in chapter 6. Following inconclusive internal exchanges, DTI wrote to Dentons on 1 May pointing out that there were no assets outwith the long term fund; asking how the terms of the draft documents could be implemented, and observing that the onus was on the Society to conform to the prudential guidance notes.

210. Before the Society's solicitors had answered, Ranson took the initiative, expressing his own concern about the difficulties facing a mutual writing only long-term business and proposing a new form of wording on subordination. Extensive correspondence followed. In the course of this, in an internal DTI memo on 9 May, it was suggested that there was effectively no problem: the intention had been to let mutuals raise capital; the use of the subsidiary was an ineffective device; and the relevant guidance note PGN 1994/1 would be amended in due course to remove any difficulties. GAD's attitude began to soften on 12 May. On 3 July Dentons made two concessions: the loan would be in sterling, and a subsidiary would be used in accordance with industry practice.

211. On 10 July 1997 Dentons submitted details of the draft documents. The documents had been based on the NPI issue. The letter stated:

> "In addition, as Equitable Life is incorporated... as an unlimited company, an additional technical paragraph has been added to Conditions 3 (Subordinated Guarantee) on page 6 of the draft Offering Circular, intended to ensure that members do not incur any liability in the event of a failure by Equitable Life to meet its obligations under the Guarantee."

A form of clause was appended. No reaction to this clause has been identified. Independent legal advice was not taken during the regulatory process, so far as the record discloses, and there was no record of internal assessment of the need for a provision to protect members of the Society, or the effectiveness of the arrangements made for that purpose.

212. By now, GAD thought the proposals generally acceptable. However, an issue arose concerning an agreed clause in an Eagle Star transaction in March to ensure effective subordination. The line supervisor, with the advice of GAD, faxed Dentons with the details. She suggested the addition of a sentence:

> "Liabilities due to policyholders must be calculated so as to fully meet their reasonable expectations, as determined by the appointed actuary to the company, with the appointed actuary also treating the loan for this purpose as if it did not exist as a liability of the long term fund at that time..."

Dentons responded that that would be a matter for the court in a winding up. DTI accepted the answer.

213. The draft loan agreement between the Society and its specially created subsidiary, Equitable Life Finance plc, reflected the intended subordination of the loan, and the provisions in favour of the policyholders already envisaged. The line supervisor indicated the department's willingness to issue a section 68 order on 18 July. After some discussion of amendments DTI agreed to issue the order. The order for £346m was issued on 19 August 1997.

214. As a practical matter, the loan issue was successful, but the proceeds were immediately absorbed in off-setting the result of changes in the tax treatment of companies' distributions. On 24 September 1997, Headdon reported to the Board that calculations of the Society's solvency position had confirmed that the combined effects of the change to the tax treatment of dividends and the issue of the

subordinated debt were such as to leave the free assets at the level which would have applied had neither event taken place.

215. So far as regulators were concerned, it appears that the liability of members of the Society for the loan debt was of low priority. The risk may not have been understood by regulators. On 9 December 1997 the line supervisor wrote to her German counterparts in response to a query about the Society's position:

> "Equitable is a mutual insurance company. This means that it is owned by its policyholders and there are no shareholders. Being a member does not involve any obligations other than the obligation to pay the premiums."

I cannot endorse this view. Equitable was and is an unlimited liability company. But it was a representation of the department's opinion of the Society's position and that of its members, and would explain the lack of response to Dentons' proposal for the protection of members. Both Allen and the FSA, who were not responsible at the time, have commented to the inquiry that the letter to German regulators was a mis-statement of the position by a junior individual and should not be taken to reflect the departmental view or the understanding of the senior staff responsible or the view of the FSA. However, this was a representation by UK regulators to German counterparts. If senior staff at the time held contrary views it is a matter of some surprise that the letter was written and sent by a junior official and remained uncorrected.

216. So the Society was granted a section 68 order permitting the debt to be disregarded in computing its liabilities on the ground that it was effectively subordinated to the interests of policyholders. In its 2002 regulatory return the Society continued to take advantage of the pre-existing section 68 order, and disregarded the liability accordingly. However, in the Society's statutory accounts for 2002, the position of the debt was described in these terms:

> "The payment of principal and interest in respect of the Bonds has been irrevocably and unconditionally guaranteed by the Society. The obligations of the Society under the guarantee constitute direct and unsecured obligations of the Society. In the event of a winding up of the Society, the claims of the bondholders under the guarantee will be subordinated in right of payment to the claims of all creditors of the Society.
>
> In accordance with the Trust Deed, where the payment of any amount in relation to the Bonds is due and the Society cannot meet the Required Minimum Margin ... of assets over liabilities required under the Trust Deed, by reference to the Insurance companies Act, 1982, on the due date (or would not be able to meet RMM immediately after such payment), then the payment (or an appropriate part thereof) will be deferred unless the FSA's consent is obtained."

217. PGN 1994/1, 'Hybrid Capital: Admissibility for Solvency' set out the regulators' guidance for insurers seeking to issue subordinated loan capital[26]. The guidance was available prior to the Society's transaction. The guidance provided that the regulator had power, by waiver or modification of the rules, to allow insurers to count the value of certain types of hybrid capital instruments towards a proportion of their required margin of solvency. The guidance described the type of instruments that would be eligible, the procedure to be followed, the admissibility limits which would apply, and the terms which such instruments should provide, in order to qualify. These terms were not to be regarded as definitive.

218. The fundamental assumption was that the conditions applicable to subordinated loans would allow the loan to be treated like the proceeds from the issue of equity for regulatory purposes. In the case of mutuals there was provision in the directive for subordinated members' accounts, the form that initially interested Ranson. These instruments were not the equivalent of ordinary share capital, but

[26] The key features of the requirements for a successful issue are summarised in chapter 6.

the regulators' main concern was that insurers should have sufficient risk capital to meet unexpected pressures on the insurance business, and it was stated that applications to count loan capital as part of insurers' solvency margin would be viewed in this light. Formally, hybrid capital instruments could not count for the purpose of covering the required solvency margin of insurers because they gave rise to liabilities offsetting the value of the funds raised. The regulator had the discretion to vary the terms of the requirement by making a direction for waiver or modification under section 148 of the Act.

219. In the calculations of regulatory solvency in 1997 and later years the debt was treated as subordinated. That was a material factor in presenting the Society's regulatory position. In the Society's office valuation the subordinated debt was treated as a contra item. Having regard to the terms of the guidance, there is no formal objection one could properly make to the treatment of the debt in the ways mentioned, once it had been authorised. But there is considerable difficulty in justifying the transaction on a broader basis. The source of payment of interest and of repayment of the capital borrowed had to be future investment returns. As such, the subordinated debt added to the demands created by reinsurance, and by the use of the future profits implicit item to accelerate the benefit of future profits and reduce the resilience of the Society to future events.

220. The inquiry has been approached by representatives of the bondholders with representations that reflect their belief that any funds that might be made available to reflect liability arising from the conduct of the affairs of the Society should be available to meet the Society's obligations to them as well as obligations to policyholders. To the extent that the Society cuts back on declared reversionary bonuses and allocates surplus as final bonus, the bondholders appear likely to assert priority. The problems associated with valuing policyholders' reasonable expectations are discussed elsewhere. But as a practical matter, there appears to be a basis for dispute between the Society and the bondholders as to priority in the application of funds while the Society remains solvent.

221. I understand from FSA that there is now controversy whether the debt takes and has at all times taken priority over policyholders' interests except in the liquidation of the Society. FSA has intimated in the course of the maxwellisation process that legal advice it has obtained states that such a view is incorrect. It is not for me to resolve a dispute of this kind, which is properly for the courts. As matters stand, on the views communicated to me, the bondholders have no incentive to seek a winding up since they would in that event lose the normal priority over policyholders' interests that they assert, and become dependent on any residual right that might have survived against members individually. In the circumstances there is an issue whether the Society should have been granted a discretionary order allowing it to discount the liability in its solvency calculations without the regulators concerned obtaining independent legal advice on which they could rely.

Scrutiny of the 1996 Returns

222. The Society's regulatory returns for the year ending 1996 were sent to the DTI on 30 June 1997 and were once again assigned a priority rating of 3 (up from 4 for the 1995 returns). On the same day an application was made for a section 68 order in respect of a future profits implicit item of £700m for 1997. I have referred in chapter 6 to the confusion that emerged over the disclosure of adjustments for expenses in this year's returns. There again appeared a statement about the Society's practice of differentiating for expenses as between bonus classes:

> "(ii) for all accumulating with profits business, an annual loading of 0.2% increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses."

The scope of the language had changed: for the specific reference to recurrent single premium business there was now a reference to "accumulating with profits pensions business", but given the proportion of that class of business to the total with profits business the change appears to have had little material significance. The quasi-zillmer adjustment was now made in the resilience calculation, but was not identified by GAD.

223. On 1 August 1997 Chris Headdon took over from Ranson as the Society's appointed actuary, on the latter's retirement, some 6 years after DTI and GAD had expressed the view that Ranson should only operate the dual role for some 12-18 months. Chamberlain's assessment of Headdon at the time was that he seemed "very competent and I think he will cope well and be a bit less 'prickly' than Roy Ranson".

224. An article in a Sunday newspaper on 3 August reacted to the announcement of the subordinated debt issue by reporting that the Society's free asset ratio was half the industry average and that experts believed the subordinated debt would not provide a long term solution.

225. On 14 October the DTI granted the Society a section 68 order, as approved by GAD, for a future profits implicit item of £700m for the year ending 1997.

226. On 17 November the National Health Service executive wrote to DTI asking about the suitability of the Society to be their AVC provider. An internal memo about the request noted that the Society's RMM cover for the 1996 returns was 2.53x and 2.07x without the implicit item. In a handwritten note, probably covering a draft reply, the line supervisor noted that they had referred to the strong solvency cover of another well-known company in reply to a similar recent request, but that the Society's cover "isn't that hot". Having considered the appropriate response, the reply to the NHS, dated 26 November 1997, stated that, based upon the 1996 returns:

> "... we would say that the company is financially sound. There are no outstanding issues of a material nature pertaining to the DTI's regulation of [the Society or its subsidiaries]."

There is no reason to view this statement as other than honest, and it is clear that some consideration was given to the reply, but as an honest assessment it reflected the poor understanding of the realistic financial position of the Society that DTI had at November 1997.

227. A 19 page scrutiny report was completed on 16 December. It opened with an 'executive summary' that stated that the Society was highly regarded, paid no commission, achieved outstanding new business growth based largely upon its reputation for low expenses, and that about 65% of its liabilities related to unitised with-profits business:

> "... for which it endeavours to show competitive annual accumulations of benefits reflecting the total investment returns achieved, but, because guaranteed bonuses include credit for a measure of asset appreciation, future bonus declarations... would seem to be vulnerable to any sustained stock market downturn. It has a modest free estate."

The report commented that some questions had been raised about the strength of the reserves established. Key features included the cover for the RMM at 2.53x, with the company having long-term assets of £19 billion. The priority rating was 3. New business had more than doubled over the last 5 years. Expense ratios were the lowest in the business. The office had achieved a mediocre investment return of 10.3%. The gross premium bonus reserve valuation published did not appear to be any stronger than its permissible net premium valuation.

228. Action points included questions about provisions for resilience, capital gains tax, and pensions mis-selling. The appointed actuary had also been asked to supply data comparing total accumulated assets shares for contracts in force with the total

assets available. Background data was largely repetitive. But the report noted that Ranson had retired in July 1997 and had been succeeded as managing director by Nash, and as appointed actuary by Headdon. The last visit to the Society had taken place on 8 November 1996. The subordinated loan was noted. Tables were provided as usual of new regular premium business income and new single premium business income for five years, in this case 1992 to 1996. It was noted that there had been an 8% increase in expenses in 1996, but that expenses ratios kept improving and had reached "astonishingly low levels". The reported expense ratios were the lowest in the industry, being only about half those of the Society's nearest competitor.

229. Tables of the recent history of asset mix, movement in asset values and changes in the portfolio were provided. A table of investment figures showed an overall rate of return of 10.3%. The information on the valuation basis and surplus contained similar material to the previous year in rather repetitive language. There were anodyne references to interest and mortality. It was noted that annuities had been valued on a different mortality table to last year and the appointed actuary had insisted in his report that the tables used contained sufficient allowance for future reductions in mortality. There was no relevant comment on the resilience calculation, despite the report of the quasi-zillmer adjustment.

230. On overall strength, the report stated:

> "The Society informs its holders of accumulating with profits contracts of the amount of their accumulating final bonus (although clearly stating that it is not guaranteed), but only holds reserves for a discounted sum compared with the current guaranteed value.
>
> It is stated in the return that final bonus additions (the accumulated amount of which are not revealed) are implicitly covered by the amount of excess admissible assets over the mathematical reserves – shown in the 1996 return as being about £1.4bn (including the RMM). However since the reserves already value current guaranteed benefit values at a combined discount of some £1.3bn, it seems likely that the total current "asset shares" (including final bonuses indicated to members) exceed total current admissible assets. The Actuary is being asked to clarify his view of the situation."

231. The report on financial results noted that the cover factor was 2.53x (both the bonus reserve and net premium methods would show a similar picture), but would be only 2.07x without the implicit item, and it was not clear that provisions made against the market value of assets for resilience and capital gains tax were as strong as they should be. It went on:

> "Because of the large proportion of business written on a participating basis and the high level of annual emerging surplus, there are not considered to be any actual potential solvency problems... but it does seem that, in the event of a marked fall in asset values, the Society might find itself in a position where it had to cut back severely the level of payout to members.
>
> It would seem desirable for the Society to hold back more of its emerging surplus by declaring lower guarantee bonuses - although it could still attempt to pay out generous final bonuses to members (preferably without raising expectations too much in advance with its declarations of "non-guaranteed final bonuses")."

The relevant part of the narrative dealing with the Society's system of bonuses was repeated to some extent from the 1995 scrutiny, but now quoted from the latest with-profits guide:

> "By passing on the balance of the overall rate of return through the final bonus, which does not add to the guarantees under the contract, the amount of final bonus is only finally determined when a claim becomes contractually payable."

232. In relation to PRE the report stated:

> "The Society tries very hard to achieve an equitable distribution to each generation of its policyholders, whilst avoiding short term fluctuations in benefits - with the result that it has not accumulated any material unallocated estate compared with accumulated asset shares (if any...).
>
> ... with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback."

At the conclusion of this passage the line supervisor recorded the following handwritten comment:

> "Take up with the company? I discussed this briefly with [the scrutinising actuary] – concern is that co. has no estate – no cushion. Should not perhaps be giving bonuses to new p. holders. But the markets are up at present."

233. Commenting to the inquiry on the line supervisor's comment, the scrutinising actuary said:

> "[She] might have got the wrong end of the stick in relation to something I said, otherwise I am not sure why she makes the comment on not giving bonuses to new policyholders. It is true that the company could get a cushion by reducing bonuses in the first year to reduce initial strains, but it depends on the marketing statements as to whether this is possible. In my estimation, the Board of Equitable had total power to alter its bonus policy if it considered it prudent to do so (acting on the advice of its Actuary)."

<u>Asset shares</u>

234. On the same day as the report was produced, GAD wrote to Headdon raising various queries including two questions that led to some extended debate. Only one is relevant for present purposes. The scrutinising actuary asked whether it was correct that total current asset shares exceeded total current admissible assets and requested a figure for the accumulated asset shares for all in-force accumulating with profits contracts at the end of 1996.

235. Headdon responded on 13 January 1998. He said that he had some difficulty in understanding the question about assets shares, but confirmed that the total face value of the policies including final bonus was in excess of the attributable assets. He went on to say that those assets would include items like new business strains and so would be higher than a pure share of the form 9 admissible assets. He went on to say:

> "... given the way we operate the business the totality of unsmoothed asset shares will be close to the value of the assets attributable to with profits business. If however you are asking about smoothed asset shares, then our bonus systems mean that the policy value, including final bonus, is effectively a smoothed asset share. Thus the total of such asset shares will be the total face value of the policies including accrued final bonus... That total figure for accumulating with profits contracts at 31 December 1996 was £14.7bn."

236. The scrutinising actuary replied on 16 January 1998. In relation to the question on asset shares, he said:

> "It is my understanding that bonus notices from Equitable... include details of accumulated <u>non-guaranteed</u> final bonuses. I do not think it is possible to derive from your Returns the amount to which such final bonus expectations have accumulated at the valuation date, and my emphasis on the level of accumulated "current guaranteed" benefits was merely intended to highlight this missing information...

I am grateful for the clear answers given... confirming my deductions about the overall financial position of the Society. The total figure for the face value of all accumulating with profits policies including accrued final bonus of £14.7bn is £3.8bn above the net premium reserve carried for this business, and this margin clearly well exceeds the amount of available free assets shown in Form 9. I am happy to confirm that this does not necessarily cause me any concern but the lack of any unitised free estate does bring to prominence the importance of not building up policyholder expectations too far – with the implication that it might then be considered necessary to hold reserves for anticipated final bonus additions. I am sure that you are acutely aware of this."

237. Headdon responded in 4 February, objecting that GAD's analysis was a bit misleading as they compared some figures derived from the net premium basis with some derived from the bonus reserve method. Additionally the assets shown were a conservative view of what was properly attributed (a point also made by GAD in their representations). Headdon continued:

"We take great care on our bonus statements to emphasise that the final bonus element of the current policy value is not guaranteed in any way. In the years we have been using this form of presentation we have, as you say, been acutely aware of the need not to build-up inappropriate expectations.

We do however feel very strongly that giving full policy values (as well as the current value of guaranteed benefits) is very useful for policyholders in planning their affairs...

At Brighton[27] some concern was expressed about declared bonuses being kept imprudently high... I would argue that that is partly due to a failure of offices to communicate the developing terminal bonus position adequately to their clients...

An annual presentation of the overall position... allows a more disciplined approach to reversionary bonuses. I think it would do a grave dis-service both to policyholder communications and the sound management of offices if quoting current policy values including terminal/final bonuses effectively became outlawed for the reasons implied by your penultimate sentence [about the need to reserve]."

The response given applied equally to the net premium valuation.

238. GAD responded on 27 February. While offering the reassurance that no consideration was being given to outlawing the Society's bonus notices, the scrutinising actuary went on to warn that:

"... it would become a matter of concern if <u>any</u> holders of accumulating with-profits contracts were ever to feel that they had been misled."

Further GAD stated:

"The manner in which Equitable operates as a mutual – giving the best possible returns to each generation of policyholders, with the consequent lack of any substantial unitised free estate, does mean that you do not have much of a cushion to enable you to protect holders of such contracts from the natural effects of future falls in the market value of assets. We remain confident that your company is fully aware of this."

239. This correspondence was passed to insurance division, now transferred to the Treasury, and the accompanying memo from the scrutinising actuary commented:

"There are no compliance points... for you to follow up, although they have agreed to a couple of presentational changes for the 1997 Returns. I also confirm that, even though our correspondence is not yet concluded about their

[27] Life Conference, November 1997 (see also chapter 12, paragraph 8).

> accumulating with-profit business, we are basically satisfied with the prudence of their reserving basis...
>
> The position revealed is very tight, since Equitable operates on the basis that, as a mutual, it should endeavour to give full value to each generation of policyholders. It therefore does not accumulate any meaningful free estate. Hence our desire to ensure that it does not build up any false expectations for its policyholders, because it would be hard for it to establish reserves for any greater liabilities than those it currently recognises.
>
> You may now consider this scrutiny to be completed."

As before, the reassurance offered in this memo appeared to reflect a view that there could be no policyholders' reasonable expectation related to unguaranteed benefits. The exclusive concentration on guaranteed benefits in the measurement of regulatory solvency could not have been more clearly expressed, and it certainly seems to have shaped the regulatory approach over a significant and critical period. If the memo did not reflect a view that PRE did not extend beyond guaranteed benefits, as GAD and those responding to maxwellisation on behalf of the regulators contend, it showed no appreciation or consideration of how PRE might extend beyond those benefits in this case.

240. Correspondence between GAD and the Society continued with a letter from Headdon on 12 March, in which he noted the comments made, but doubted there was much more to be said. He suggested that the points might become clearer in the 1997 returns. In relation to a separate topic, the Society's practice in relation to surrender values, Headdon explained that the Society was applying an MVA to surrenders at 31 December 1997 in certain circumstances, at that stage by a reduction in final bonus[28]. He continued:

> "That was presented as a reduction in final bonus but could equally be regarded as some discounting of the value of guaranteed benefits. In some cases, that would have led to a surrender value of benefits (excluding final bonus) below the level of the reserve held. I could not, however, state categorically that the non-contractual surrenders we were actually paying on 31 December 1996 were, in all cases, lower than the mathematical reserves held."

He said that if the Society had been experiencing a significant volume of surrenders management could exercise the right to reduce further the values paid - possibly to below the level of the mathematical reserves in all cases - in order to protect the fund.

241. The scrutinising actuary replied on 21 April suggesting a meeting. He stated:

> "The whole area of the appropriate bonus methodology to be used for accumulating with-profits business, the expectations built up for policyholders and the establishment of proper reserves has become more difficult as a greater proportion of investment returns is being derived from asset appreciation – which could prove to be ephemeral."

242. The suggested meeting took place on 28 May and was attended by Chamberlain, by the scrutinising actuary from GAD and by Headdon from the Society. No one from HMT was invited to attend although they were aware of the meeting in advance. The results of the meeting were communicated to HMT by a memo from the scrutinising actuary on 8 June. The memo stated, among other things, that:

> "I have already indicated that we considered our scrutiny of the... 1996 Returns to be closed, and I am happy to confirm that our discussions did not conclude that any particular strengthening of their reserves was needed in

[28] See the Foreword, paragraph 3 and footnote 2.

> relation to accumulating with-profits business, although I remain somewhat concerned that not all holders of such contracts (with this and other offices) appreciate what could happen at future bonus declarations if we saw a sudden downturn in the market value of assets. The whole industry is relying on a soft landing, so that reductions can be achieved gradually and without trauma."

With the memo was enclosed a letter the scrutinising actuary had sent to Headdon on the same day thanking him for the visit and noting:

> "... it is clear that we are agreed that great restraint should be exercised in relation to the setting of guaranteed bonus levels at a time when a large part of investment returns is being derived from capital gains.
>
> We appreciate the openness of your current bonus structure for this business, and the clarity of the NOTES included in your Bonus Notices, but we remain wary that some of your policyholders still may not appreciate that levels of non-guaranteed final bonus might actually be reduced from one declaration to the next. We understand that the only research done to ascertain the understanding of your bonus notices is related to an analysis of telephone enquiries received, and would suggest that such enquiries might reflect a lesser understanding than in recent years if a time arose when total attaching bonuses were necessarily cut - although we do recognise that other companies would be likely to generate disappointment at an earlier point than Equitable."

With hindsight, the confidence in the Society's ability to survive unscathed the trials and tribulations that might be expected to afflict others appears naïve. Again the underlying view appears to have been that provided benefits were not guaranteed they did not enter materially into the assessment of policyholders' reasonable expectations.

243. Headdon had prepared his own note of the meeting, which said:

> "The meeting was fairly unstructured and went through somewhat of a ragbag of not particularly well thought through concerns that they have. However, their main points seem to be:
>
> (i) Declared bonus rates are still too high.
>
> (ii) That offices have been incautious in distributing recent high capital returns and have not made sufficient allowance for the fact that such returns may reflect a "one off " adjustment to a lower yield basis or could be reversed to a significant degree by a change in sentiment.
>
> (iii) That the way benefits have been presented to policyholders restricts the ability of offices to make significant changes to terminal bonuses without severely damaging policyholders' perceptions of them."

Headdon's note reported that GAD seemed to think that the Society was more exposed in those areas than other companies because of their full distribution policy and some anecdotal evidence about policyholders believing their full fund value was guaranteed. Headdon recorded that he had sought to refute this, citing in relation to (iii) above the fact that after the 1997 declaration (3% reversionary and 6½% terminal) some policyholders had phoned in to complain that too much was paid by way of final bonus and thereby remained at risk. (I note GAD's view, expressed in their representations, that this is evidence that rolled-up policy values did not create PRE in respect of final bonus, but I regard it as a wholly insubstantial basis for generalisation.)

244. Headdon's note then recorded that GAD had asked about the current relationship between policy values and underlying assets.

> "... I said that I thought currently assets were around 105% of policy values (that was based on policy values being approximately 96% of asset values at 31.12.97 and actual earnings of 11% with an allocated return of 3% over the first 4 months of 1998). They asked what I would regard as the normal range

> for the relationship between those two items and I said plus or minus 10% although there could be circumstances in which the relationship would need to move outside of that range temporarily."

Headdon observed that GAD had stated at the end of the meeting that they were considerably more reassured about the Society's approach. He concluded by saying that there had also been some general conversation about some other issues, amongst which he listed "Reserving for annuity guarantees". No detail of that discussion was recorded in his note.

Discussion of the 1996 Scrutiny

245. Equitable had experienced a below average year on the market with an overall investment return of 10.7% (including an income yield of 5.6%). The Society had announced a total growth rate of 10% (the same as for 1994 and 1995) which was comprised of the 3½% GIR, 4% reversionary bonus and 2½% terminal bonus). Part of the cost of the bonuses was met by a call on capital appreciation of £340m. The residual unallocated return went some way to reducing the excess of aggregate with profits policy values over assets to 111% (112% in 1995). The accrued final bonus figure now stood at £2.9 billion. The interest rate used in the liability valuation was reduced from 5% to 4¾% as against a gross bonus rate assumed of 4%. This change resulted in a further strengthening of the liability valuation basis. The regulatory cover factor had fallen to 2.53x (from 2.9x in 1995) and included credit for a future profits implicit item of over £300m (without which the cover would have been 2.07x).

246. The 1996 scrutiny report reflected an increased level of interest in aggregate accumulated asset shares and available assets, among other issues bearing on policyholders' expectations of life offices' performance. One has an impression of apprehension that the industry as a whole was over-dependent on capital appreciation, and on continuing out-performance of equities in particular to recover from over-distribution. The sensitivity of Equitable to market volatility appears to have been reflected in heightened concern about the overall strength of the valuation basis. But on the basis of the documents, I can only conclude that GAD and DTI remained committed to the view that the measure of reserving requirements and PRE were alike related to guaranteed benefits, and that unguaranteed benefits did not come into the reckoning in either case.

247. In keeping with this approach, the 1996 scrutiny report suggested, for the first time in a scrutiny report, that it would be "desirable" for the Society to hold back more of its emerging surplus by declaring lower guaranteed bonuses, while keeping up generous final bonus payouts, as long as expectations were not raised. The picture that emerges is of a very incomplete understanding of the statutory requirement, and a narrow approach to the assessment of PRE. This was the first scrutiny report to have a specific heading entitled PRE (within the bonus section). Despite this, there seems still to have been no system in place (nor any in contemplation) by which PRE might have been actively assessed.

248. The correspondence which followed the scrutiny and continued until the May 1998 meeting appears to me to show that whilst GAD were becoming increasingly concerned about the Society's vulnerability, bonus notices and PRE (particularly in light of the "very tight" position revealed in the returns, and Equitable having supplied figures for the excess asset share position), they viewed their remit in this area as limited to one in which they sought and received reassurance from the Society that they were alive to the problems. Chamberlain has told the inquiry that at the time of the 1996 scrutiny, he and the scrutinising actuary:

> "... shared a mounting disquiet. We would have liked things with Equitable to be more stable. However they didn't have any particular problems, the market was relatively stable, they were not breaching their RMM and they had the necessary reserves. The cause of our disquiet was that, if they faced an unexpected challenge, they would have difficulties coping. The regulatory system didn't allow intervention on such grounds. Managing the business and

its risks was a matter for management. We tried, therefore to try and build up as strong a case as possible to get Equitable's management to do something to protect themselves, whilst keeping a close eye on PRE issues to see whether there was any basis for the DTI to intervene on a PRE basis.

I am still doubtful if there is much that can be done today but the EU is liberalising regulatory powers so the position is improving. The FSA has more freedom to impose higher capital requirements. Certainly we never gathered enough evidence to establish grounds to intervene based on PRE."

249. It was consistent with the approach described by Chamberlain that at the meeting of 28 May 1998 the GAD approach appeared to amount to an attempt to have the Society gather its own evidence about PRE. Chamberlain has told the inquiry that:

> "We suggested that the Equitable undertake market research to see what their policyholders expected, but it did not do so. We were trying to encourage them to see that their transparency, widely considered to be a great thing, had the potential to create problems for them... It was a hard struggle to persuade Headdon that there were issues here."

The inquiry has recovered no evidence that GAD or DTI or Treasury were gathering any company-specific evidence themselves, or more importantly that they considered it even within their remit to do so. Allen has confirmed that they did not "monitor companies' PRE on a regular basis", which he has noted (after the historical position identified by the inquiry had been disclosed) was consistent with the approach decided on in 1972. However, he has also told the inquiry that PRE was considered to be within their remit, and that they "did monitor PRE when [they] had evidence that PRE might not be met". I take this to mean that evidence on what would form the reasonable expectations of policyholders would be sought as and when particular questions regarding PRE were raised.[29]

250. With reference to the post-meeting letter that GAD sent to Headdon, Chamberlain has told the inquiry that:

> "The aim of our letter, and our discussions generally, was to persuade him, to encourage him to take a safer course, by considering issues further and researching policyholders' expectations, and generally to act as necessary to ensure the long term health of the Equitable. Headdon did not consider that the Equitable had any difficulties."

251. Whatever level of concern was developing within GAD, and being expressed on these various issues, the documents available do not reflect any corresponding concern on the part of the Treasury, or appreciation that GAD may have been communicating concern to the regulator. Commenting on the GAD memo reporting the outcome of the 28 May meeting, the line supervisor told the inquiry:

> "In this note [the GAD actuary] states that he remains somewhat concerned that not all policyholders appreciate what could happen if there were a sudden downturn in the market. [The actuary] raises this in his letter to Mr Headdon of the same date (a copy of which was attached to the note to me)... I have been asked about the role taken by the DTI on this issue. As GAD were dealing with this issue and corresponding with ELAS about it, the DTI would not have interfered in the correspondence. GAD was taking responsibility on this and I don't recall myself ever being involved in this. If GAD thought regulatory intervention was necessary they would have no doubt informed us."

[29] In the course of maxwellisation, Allen has contended that this comment implies an unusual use of the word "monitor". The Treasury have suggested that the comment is inconsistent with subsequent evidence that they asked for this information in September 1998. In the context of a chronological account there does not seem to be any conflict. The Treasury also suggest that the quote from the 8 June 1998 letter to Headdon, which included reference to the clarity of the notes in the bonus notes, may contradict this. I do not accept these representations.

The Treasury remained wholly passive, depending on GAD to initiate any action required[30]. In response to material in the 1996 scrutiny report the line supervisor stated:

> "... [the report] states that because guaranteed bonuses include credit for a measure of asset appreciation, future bonus declarations would seem to be vulnerable to any sustained stock market downturn. I have been asked for my reaction to this. I would have been aware of this but it does not appear in the Key Features section of the scrutiny (which would have indicated that it was something that we should pay attention to). [The scrutinising actuary] does not comment or suggest that we need to take action on this. We would not have been concerned, as GAD had not highlighted this as an issue".

Although the issues were brought to the attention of the more senior members of the supervisory team, no documents have been found which reflect any concern being expressed on their part at this time.

252. In relative terms, this was a period of calm before the annuity guarantee storm broke over the Society and its regulators. Concern was growing, but remained low-level. HM Treasury appear to have been content to allow GAD to conduct the dialogue with the Society without active Treasury participation. The Treasury have suggested to the inquiry that this was consistent with the service level agreement (a revised agreement was concluded in December 1998). However, reading the service level agreement only deepens the impression that any broader regulatory view that might have been formed was being subordinated to on-going technical discussions on a purely actuarial basis. It was a transitional phase in the development of regulation. It is difficult to avoid the view that regulation was falling between two stools, the major player in discussions having no regulatory power, and the empowered regulator having little part in the processes that would have instructed regulatory action.

[30] In their maxwellisation representations, the Treasury have pointed to the letter sent in September 1998 as evidence that the Treasury were concerned and not passive. The September letter was sent on the advice and prompting of GAD. In any case it was after the events being commented on here.

CHAPTER 17: EMERGENCE OF THE GAR ISSUE

1. In 1997 the Society experienced an average year on the market with an overall investment return of 17.2% (including an income yield of 5%). It announced a total growth rate of 13% (an increase from 10% allocated each year since 1994), which was comprised the 3½% GIR (although this was now zero for new policies), 3% reversionary bonus and 6½% terminal bonus). This placed the balance as between reversionary and terminal bonus at 32/68, its most extreme yet. Part of the cost of the bonuses was met by a call on capital appreciation of £1.6 billion. The residual unallocated return went some way to reducing the excess of aggregate with profits policy values over assets to 107% (111% in 1996).

2. The accrued final bonus figure now stood at over £3.8 billion. The interest rate used in the liability valuation was reduced to 4% (4¾% in 1996) as against a gross bonus rate assumed of 4%. Equilibrium in these rates had been restored. The regulatory cover factor had fallen slightly to 2.51x (from 2.53x in 1996) and included credit for an implicit item of £370m and for the subordinated loan of £350m. Without these additions the cover would have been 1.66x. The returns for 1997 were not subjected to any formal scrutiny until the spring of 1999.

3. During the normal time frame for scrutiny (towards the end of 1998) the GAR issue had already exploded and was dominating the regulators' concerns. It is therefore appropriate to deal at this stage with the emergence of the GAR issue and the approach taken by HMT/FSA and GAD up until the issuing of guidance letters in January 1999.

Working Party on Annuity Guarantees

4. In January 1997 an actuarial working party was set up to consider the issue of annuity guarantees which because of low interest rates and improving mortality had become "potentially very valuable". As far as the Society's guarantees were concerned, the conversion rate in possession had exceeded the current annuity rate for the first time from October 1993 until May 1994 and thereafter from May 1995 onwards. The working party's terms of reference stated that:

> "... there is no accepted practice for reserving for these guarantees and there is no published research to guide Appointed Actuaries in setting reserves. The DTI have not published any guidance or regulations specific to annuity guarantees."

The thrust of the reference was that neither within the actuarial profession nor within the regulatory framework was there specific guidance on reserving issues. There was, however, a clear requirement to value all guarantees in the regulations. Further, there was published research on stochastic modelling and practical papers on its application in life business. But it would have been accurate to say that the use of the available techniques had not been accepted as practice standard.

5. The objectives of the working party were as follows:

   i. To determine the different types of annuity guarantee and the volumes of such business;

   ii. To determine current practice in reserving for the guarantees;

   iii. To conduct research into the cost of the guarantees under different investment and mortality scenarios;

   iv. To consider PRE issues in relation to such guarantees on with-profits policies;

   v. To consider and recommend appropriate reserving bases; and

   vi. To prepare a report summarising the research and its conclusions.

The report was to be published and discussed at the 1997 Life Conference. One of the members of the working party was an actuary from GAD.

6. The working party's report was duly published in November 1997 and it reached the following conclusions:

i. The guarantees applied to just over 10% of the liabilities of the companies which had responded to the survey, which accounted for over 90% of the total industry liabilities;

ii. The future cost of the guarantees would depend on interest rates and mortality;

iii. The cost would also depend on the way in which companies applied the guarantee in practice;

iv. On with-profits business, companies also had the opportunity to take account of guarantees when setting bonus rates. This could reduce the cost of the guarantees but might raise PRE issues;

v. There was only limited evidence that companies had started to address the issues in (iii) and (iv) above and they would need to do so in the relatively near future;

vi. A sensible range for the industry wide costs might be 0-20% of liabilities or £5-10 billion, but the impact on some companies would be more significant;

vii. There was no industry consensus on reserving for guarantees and current practice was very varied. Some companies had yet to work out their approach; and

viii. The variation between products and approaches meant that the working party felt unable to recommend the approach to be taken to reserving for such guarantees.

7. Specifically on the issues of reserving for with-profits contracts, the report identified three approaches and gave an assessment of each:

1. Approach: Set aside additional reserves related to the prudent estimate of costs of the guarantees.

   Assessment: This was the most prudent approach. However the adverse impact on published survey ratios for an office adopting this approach in isolation might make it unattractive. It may also raise the need to consider to what extent it was reasonable to allow statutory reserves to exceed asset shares.

2. Approach: Recognise the costs of the guarantees as effectively increasing the guaranteed sum assured on some prudent basis and the recalculate the net premium reserves accordingly.

   Assessment: This approach appeared rather arbitrary in its effect on the overall strength of the valuation base.

3. Approach: Review whether and to what extent the guarantee will be covered by terminal bonus adjustments.

   Assessment: This approach could be viewed as unsound because no explicit provision was made for an explicit guarantee.

The report went on to state that "no approach is entirely satisfactory"[1].

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[1] It is not clear when the working party report was first received by the Treasury. A copy was found in a policy file entitled 'GAOs' and within that file amongst other documents dated December 1998 and nowhere else within the DTI/Treasury files that the inquiry has seen.

8. I do not think it would be unfair to observe that the report itself was not entirely satisfactory. Professional bodies that confer privileges on their members have corresponding obligations to ensure that there are sufficient and effective professional standards by which to measure members' performance of their duties to their clients and the public. Recognising the idiosyncratic practices of individual members is not an acceptable substitute for a definition of generally acceptable professional principles or practices. Annuity guarantees had been written by the Society in the second quarter of the twentieth century on FSSU business, and such guarantees were widely available on retirement annuity business in and after 1956. The inability of a professional working party to identify and describe an 'entirely satisfactory' approach to the actuarial computation of the resulting liabilities at the end of the century is remarkable. Whatever else it demonstrates, it is proof of a failure to consider and resolve the issue over decades during which policyholders' contributions were taken under deferred annuity contracts some of which did and some of which did not provide annuity guarantees, and actuaries advised life offices, and appointed actuaries certified regulatory returns, without their professional bodies addressing the need for standards or for guidance relevant to the treatment of attendant liabilities.

9. Chamberlain has given the inquiry his view of the genesis of the problem, and how it came to his attention:

> "The GAO [guaranteed annuity option] crisis resulted from the combined effect of lower interest rates and lighter mortality. Companies can see changes in interest rates, but lighter mortality rates are not seen on the same daily basis. Although there was some regular data on mortality... these were only an annual snapshot, and had too much statistical "noise" for anyone to gauge the effect of the mortality changes year on year. Chris Daykin [the Government Actuary] got these reports as he was on the relevant committee and he passed them to one of the Chief Actuaries. I think I got my first mortality report in 1997, based on 1995 data... Every 4 years the reports would be made public in a more useable form. These showed the longevity improvement but did not highlight the fact that the rate of change was also speeding up. This only became apparent over time when the working party... discovered this by smoothing out changes and rebuilding rates of change of mortality. GAD's first concern about mortality changes was for the reserves on annuities in payment and future deferred annuities... but it became obvious over time that the guarantee issue was also a problem...
>
> Although we had all along known of GAR style policies, it was not until the Faculty and Institute working party published their findings at the "Current issues in life assurance" meeting in Spring 1998 that we appreciated for the first time that there had been this sudden movement into the money for so many. I was staggered to hear the news of the more generous GARs like Equitable's as there were others set at rates of 2% and 3% which equates to 4% or 5% with mortality considerations... [There was a GAD actuary] on the GAO working party... but he could not tell us about their results in advance."

On his approach the need to consider the issue depended on the emergence of a practical problem, rather than as a matter of principle.

10. On 18 June 1998 Hewitson wrote to Roger Allen at HMT with a questionnaire about annuity guarantees which GAD proposed to send to all life offices. The letter acknowledged that GAD's own survey had come about because of the working party's report and the fact that the regulatory returns did not provide sufficient information about the exposure. Allen agreed to the survey (albeit with a strong hint that HMT should have been consulted earlier), and on 20 June Hewitson wrote to appointed actuaries with the questionnaire and the observation that:

> "... given the trends in recent years in both pensioner mortality and market interest rates, we are conscious that a number of these guarantees may be of increasing significance to the financial management of individual life insurers."

11. The Society responded on 29 July[2]. Headdon signed off the response. It said that the Society's retirement annuity product, some individual pensions, transfer plans and group pensions contained annuity guarantees up until 1988. From 1979 the guarantees had been based upon an a(55) mortality table and an interest rate of 7%. The provision for the guarantees within the total mathematical reserves for those products was nil, and no explicit provision was made for the guarantees in setting either the mathematical reserves or the resilience reserves. The response also confirmed that the Society had seen the working party report, and stated that their approach had not been modified in light of the recent debate within the actuarial profession about annuity guarantees.

12. Most critically, the response revealed that the Society did not make a general allowance for the guarantee when establishing maturity values (e.g. by adjusting the asset share calculation), but that in any policy where the guarantee was biting, it reduced the amount of terminal bonus already computed to meet the cost. It was reported that:

> "For all but a few small policies, the 'cost' of the annuity guarantee is covered by this adjustment".

Policyholders were not advised when they reached retirement of their right to payment of a guaranteed annuity. As the business to which the guarantees applied aged, the response noted, the "terminal bonus cushion [would] make it increasingly unlikely that guarantees [would] actually bite".

13. The operation of the differential terminal bonus policy had been made clear.

The Regulatory Response

14. Rathbone has told the inquiry that, in relation to this revelation of the differential terminal bonus policy:

> "We were surprised when we read this, as we were not aware of such practices. In addition, if they had committed some part of the terminal bonus they should have reserved that part."

Rathbone would have been aware that some offices followed the practice after publication of the working party's report.

15. On 13 August 1998 Chamberlain, who had assumed a degree of responsibility for the annuity guarantee issue, wrote to HMT enclosing a paper he had written about the issue generally. He discussed the matter in terms of 'guaranteed annuity options', reflecting an economic rather than a legal view of the contractual provisions. The paper stated:

> "Companies now face a significant problem with regard to these options. The scale of the problem is the subject of an investigation being conducted in GAD at present."

The paper was primarily about using derivatives as a solution to the problem, but amongst the issues he raised were the questions of whether it was in accordance with PRE to vary terminal bonuses according to the cost of the annuity guarantees, or according to their incidence. Chamberlain went on to state:

> "Whatever is the technical position, it must be remembered:
>
> - these GAOs exist in large numbers, and threaten solvency in many cases and policyholders' actual, if not necessarily reasonable, expectations in more
> - derivatives are a natural way to protect the interests of policyholders

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[2] Although it does not appear that HMT received a copy of the Society's response until mid-September, see paragraph 20 below.

- there is a risk of these becoming the regulator's problem!"

Under the heading 'PRE' the paper discussed the pros and cons of the differential terminal bonus approach. The argument against was that, on one view, the terminal bonus having been described, PRE had been created, that it was based upon the open market option, and that, to the extent that the GAO applied to the full sum, "the full pain must be borne". The paper concluded:

> "There is probably no solution to this issue on an industry basis, as it probably is a function of policy wordings, marketing material, with profits guides and similar items."

By the end of August HMT were also aware of press interest in the guarantees.

16. An internal FSA memo dated 28 August 1998 made it plain that so far as the conduct of business regulators were concerned, because the issues related to policies sold many years ago, before PIA was established under the Financial Services Act, and related to after-sale administration, they were outside of their scope. This early memo indicated a mindset that was to dominate the conduct of business approach to these guarantees as the issue developed. The view depended on the understanding that in all contracts there was a single date of sale. The characteristics of recurring single premium business, in my view more properly characterised as a succession of sales, were not discussed. The memo concluded by noting that the subject raised the question of solvency, and that the insurance division of HMT were also investigating. FSA in response to maxwellisation have drawn my attention to the fact that they sought and obtained legal advice on 16 June 1999 on this issue. In relation to Equitable that was late.

17. On 1 September Chamberlain wrote to Allen about the GARs and a number of the issues which he felt were relevant, amongst which was this:

> "*What about avoiding contractual obligations?*
>
> ... HMT has a duty to ensure [PRE] are met, and the denial of a contractual right by misconduct is a serious matter...That said, policing the issue is more difficult. By the very nature of the issue, it can only be verified by reviewing individual cases. This can be done reactively, by waiting for complaints, or proactively, by audit of files. This would require considerable manpower to be effective as a detection or even a deterrent mechanism."

The letter ended by recommending the following as the best course of action for HMT:

- Circulate all companies about the guarantees and identify the avoiding of such obligations as unacceptable;
- Ask all companies to report on their procedures to ensure that GARs were applied on maturity option quotations and that the existence of options was known (to which was added the comment, "Is this going a step too far?");
- Any complaint from a policyholder or IFA would trigger a visit to review said procedures;
- Any subsequent failures should result in a 'section 43a investigation', including a sample review of files;
- If a substantial problem were found, action would be necessary, including a review of cases and 'fit and proper' action.

Chamberlain concluded:

> "A more proactive course, reviewing companies routinely, would seem to be too intensive in resources to be practical. It is also arguably a significant overreaction to few if any recorded incidents. It is open therefore to criticism as a misuse of powers."

Commenting on Chamberlain's letter, Hewitson told the inquiry that it:

> "... reflected Andrew Chamberlain's own views. There was some comment later that this overstated the responsibilities of HMT as the Regulator. Andrew Chamberlain tended to write his own papers and to develop issues without referral upwards."

Roger Allen replied to Chamberlain two days later and suggested a meeting towards the end of September to discuss these and other related issues.

18. On 3 September 1998 Allen also wrote to Michael Foot, the FSA managing director responsible for authorisation and supervision, mentioning the recent press interest and briefing him about the action HMT and GAD were taking, i.e. the issuing of the questionnaire and the analysis of responses. He said:

> "We are also considering the implications for the fulfilment of policyholders' reasonable expectations."

The memo was copied to Michael Folger, director of the investment business division at FSA on the grounds that the conduct of business side of FSA, for which he was responsible, would also have an interest in the guarantees, and that it was "an issue on which we will need to work closely together to ensure a seamless regulatory approach".

19. At some point in September it would appear that GAD compiled a preliminary report on the survey results. The report, which was sent to HMT in November, identified the Society as particularly vulnerable because the relevant business was about 30% of its total book. According to the report the Society was also one of five companies which as a result of reserving practice could be technically insolvent.

20. On 15 September GAD sent HMT a copy of the Society's survey response, pointing out the basis of the guarantees quoted (i.e. the a(55) mortality assumption and the 7% interest rate) and the investment yield of about 9% (which was not then available) required to fund the obligation. GAD pointed out the Society's solution of the differential terminal bonus policy, but suggested that HMT explore this subject further (particularly as regards PRE) by asking the Society to provide any documents supporting its approach. HMT wrote to the Society in these terms on 21 September.

21. On 25 September, following GAD's recommendation, the Society were granted a section 68 order in respect of a future profits implicit item of £850m.

22. Nash replied to HMT's letter on 29 September 1998. He explained that:

> "In a mutual with profits fund the key question is, of course, how the potential costs of guarantees should be reflected in bonus rates".

The letter went on to argue that the differential terminal bonus policy was "the fairer course", and one which produced benefits of equivalent value as between the open market cash fund and the annuity guarantee. As for the documentation in support, Nash went on to say:

> "... the Society has always described its approach to bonuses in the most general terms in marketing literature... the comments we have made about bonuses have focused on principles such as fair treatment between different classes of business, that bonuses are primarily determined by the level of investment returns over a contract's lifetime, and that our aim is to pass on the smoothed earnings achieved on the contributions made during a policy's term... We have also taken pains in all our illustrations, literature etc to make it very clear that final bonus is allotted only at the point of retirement, that the amount can vary and that any amount shown is not guaranteed."

In support he enclosed various annual statements, bonus notices and booklets[3].

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[3] A booklet entitled 'Retirement Policy for the Self Employed' which seemed to date from about 1984, bonus booklets from December 1994 and one which seemed to date from about 1985, a policyholder

23. Nash went on to say that the differential terminal bonus policy had been introduced at the end of 1993, and had been disclosed in the returns in each year since and mentioned in annual statements to policyholders since the end of 1995[4] (although omitted in error from 1997 statements). Nash had not enclosed with the letter any annual statement from before this date. The line supervisor acknowledged the letter on 30 September and asked for an example of a GAR policy document. This was supplied by fax the next day.

24. Thus the Society's presentation of its terminal bonus, about which GAD had been expressing concern as recently as May that year and as long ago as 1994[5], had come under the spotlight.

25. On 2 October 1998 there was a meeting called at HMT's request to discuss the Society's approach to the annuity guarantees and the solvency implications of reserving for them[6]. According to the HMT minutes, the Society defended the differential terminal bonus policy as a fair way by which to treat all policyholders equally. They contended that the terminal bonus was at the discretion of the directors and that they had powers to vary it as between different classes of policyholders. Rathbone commented that it was not clear to him that the wording of the guarantee was open to this interpretation (ie it offered the unadjusted cash fund converted using current annuity rates or the guaranteed rate). The Society was confident that it had not broken any promises and said that it had received support for its position from counsel. As regards PRE, Nash said that he would be concerned if they treated one set of policyholders differently to another. The Society agreed that many of the policies allowed the payment of additional premiums, "but this was not seen as a risk because of the treatment taken with respect to asset shares".

26. On reserving for the guarantees, it was confirmed that the Society had made no reserving provisions for the guarantees and that 80-90% of them were on the a(55)/7% basis. GAD expressed the view that guarantees should be provided for in the valuation basis, irrespective of whether or not they were currently biting, but Headdon argued that it would not be appropriate to reserve fully for guarantees if only a small proportion of policyholders chose the guarantee and two thirds were taking the cash benefit. Rathbone pointed out that the take up rate would increase as the guarantees became more valuable. GAD argued that the Society needed to look at all its guarantees and options "and make appropriate reserves". Nash observed that reserving for the annuity guarantees "could have severe consequences for the company...".

27. The action points recorded in the minutes were that the Society would provide a revised assessment of the required reserves, and GAD and HMT would consider the status of the future profits concession in light of that[7]. It was also agreed that the Society would make a reassessment of solvency. The minutes concluded as follows:

> "Concern was expressed from the Equitable that tougher regulatory controls on the industry, such as the need to increase margins in reserves for problems such as pensions mis-selling and GAOs could in the current climate tip companies into insolvency. Roger Allen agreed that a balance needed to be found and that he took into account the company's concerns."

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bonus notice from 1995, a policyholder annual statement for the year ending 1995 and with profits guides from 1998 and 1995.

[4] See chapter 16, paragraph 193.

[5] See for example Chamberlain's views recorded at paragraph 157 of the previous chapter.

[6] See chapter 1, paragraph 31. The Society were represented by Nash, Headdon and Thomas, Allen and the 2 line supervisors attended from HMT and Hewitson and Rathbone from GAD.

[7] In the course of their maxwellisation representations, the Treasury invited me to reconsider my conclusion that the approach to s68 orders was mechanistic in light of this action point. I regard the attempt to generalise on the basis of this point as fanciful.

Work Begins on Guidance

28. On 9 October there was an important development in the regulators' approach to annuity guarantee issue. Hewitson wrote a memo to HMT in which he expressed the view that some guidance about PRE and annuity guarantees should be issued to all companies. He went on to suggest that:

> "As a starting point, I believe we could say that policyholders with such annuity guarantees or options on guaranteed terms could reasonably expect to pay some premium, or charge, towards the cost of these options and guarantees."

He considered a variety of ways in which this cost might be deemed to have been met, and then continued:

> "As a consequence... we would expect that for most companies the present guaranteed cash benefits (including declared bonus) would be converted, as a contractual minimum, to annuity on the guaranteed terms. However the appropriate final (or terminal) bonus may be somewhat lower than for contracts without such options or guarantees, and could be converted at current annuity rates."

He went to say that the adjustments made would have to be assessed in the context of PRE by each office, as influenced by the policy documents and other representations made (eg bonus statements etc). In the light of later developments it was unfortunate that Hewitson suggested in such general terms that policyholders could expect to pay a charge without qualification as to when, and therefore implied that it might be levied up to maturity, and that he gave the impression that terminal bonus could be reduced where annuity guarantees applied[8]. Despite his references to the contractual context and PRE, the primary suggestions were significant in their impact on the Equitable position in particular.

29. On the face of the letter, Roger Allen wrote to the senior line supervisor:

> "I think we need public guidance (+ Ministerial endorsement). This text is an excellent basis."

The approach taken to annuity guarantees in Hewitson's note, as endorsed by Allen, came to be reflected directly in the HMT guidance letter that would be issued on 18 December. In addition Hewitson's note provided support for the course of action the Society had decided on, and seemed to reflect none of the notes of caution contained within Chamberlain's August paper or 1 September letter. Hewitson has told the inquiry that "GAD never held the view that the guidance endorsed Equitable's position", but I cannot read the guidance relative to the Society's practice without forming the impression that there was support that the references to contract and context failed to qualify it effectively[9]. Within the available documents the inquiry has found no record of any debate or discussion between GAD and HMT about the assertion that policyholders could reasonably be expected to pay some charge

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[8] In their maxwellisation representations, the Treasury suggested that I should explicitly acknowledge part of the letter which read:
"The level of the charge deemed payable by participating policyholders for the annuity options and guarantees... would we understand generally be assessed by reference to their perceived value over the duration of the contract. The selected treatment by each office would though depend on the wording of their contracts and how these are presented to policyholders"
I do not accept that this addresses the point. The basic proposition remained that the charge might be made at any time up to maturity, and, in some cases be met by reducing terminal bonus.

[9] In their maxwellisation representations the Treasury, drew attention again to the caveat referring to the "wording of the contract ..." referred to in the previous footnote and suggested that the guidance was neutral. My view was formed with those references in mind, as indicated in the sentence. I do not accept that there is any need to alter my assessment.

towards the cost of the guarantees and, if this was right, whether it was acceptable for it to be charged ex post facto.

30. Ministerial endorsement of the proposed guidance was sought on 19 October 1998 in a submission to the Economic Secretary to the Treasury, which addressed both the particular position of the Society and the proposal to issue guidance. The impression that the regulators were in essence supportive of the Society's approach is reinforced by the statement in the submission that:

> "We have discussed the situation with the company, and our initial view, on the evidence we have seen to date, is that the company's approach appears to be consistent with the terms of the contracts sold, and that the company is endeavouring to fulfil the reasonable expectations of all its policyholders. In particular the company is fully aware that any increase in the level of bonuses for policyholders with annuity guarantees would very likely lead to reduced bonuses for other policyholders. We are continuing to explore the position with the company."

On the matter of general guidance, the submission advised:

> "We take the view that it is reasonable for policyholders to be required to pay some premium or charge towards the cost of a guaranteed annuity option provided that this possibility was allowed for in the terms of the contract. Accordingly we propose to prepare and circulate guidance to the insurance industry to the effect that making some charge for the options is acceptable provided that this does not conflict with the overriding requirement to meet policyholders' reasonable expectations. We propose to submit this guidance for your approval shortly."

The draft guidance was submitted for approval on 26 October 1998.

31. The response from the Minister's private office dated 19 November stated that the Economic Secretary was not at all happy with the guidance and wished for a fuller justification before going any further. The memo recorded that:

> "The Minister has commented that surely if people bought a contract, it is a guarantee and they should not now expect to pay for the guarantee themselves."

In my view the response reflects a degree of confusion within the draft between contractual provisions and PRE[10]. If a contract had provided for an additional premium for the provision of a guaranteed annuity (as the Society's old FSSU contracts had done), there would have been no issue. If the premium base had included provision for the cost of providing the guarantee, it would have been improper to charge a second time. The natural assumption was that spelled out by the Minister: the policyholder would understand that what had been promised in the policy was what had been paid for. It is more than a little difficult to understand how policyholders' reasonable expectations could have generated a liability to pay or to suffer a charge ex post facto for a contractual benefit.[11]

32. However, Allen has told the inquiry that he does not accept that there was confusion in the draft. He has observed that the purpose of the guidance was to establish a framework of principles to assist the industry. The issue was how far the discretion inherent in the operation of a with-profits fund could be applied to cover the cost of annuity guarantees; more specifically, whether it was consistent with PRE to adjust final bonuses to pay the cost of the guarantee where this was not explicitly excluded by the terms of the contract. The view expressed by the Minister

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[10] In their maxwellisation representations, the Treasury invited me to reconsider this conclusion in light of passages quoted. I see no need to change my view.

[11] In their maxwellisation representations, the Treasury has contended that neither the submission nor the guidance suggests that an ex post facto charge was consistent with PRE. I consider that the comment is appropriate in the light of the documents as a whole.

reflected one side of that argument. The guidance did not rule out the alternative possibility, subject to the circumstances of a particular fund and the terms of its contract. It appears to me that these comments support the view that there was confusion in the documents[12].

33. In the meantime Headdon had written to Hewitson on 30 October 1998 to provide more information about the Society's annuity guarantees and the associated reserving issues (as agreed at the 2 October meeting). Within the letter Headdon stated that of those for whom a GAR would provide a higher level of income, none had as yet chosen to take that option. However on the basis of the worst case scenario (ie 100% of benefits taken as conventional non-profit annuities) the value of the additional annuity payments would be £170m. However, Headdon said that this scenario was unrealistic and that it was felt that "the commercial cost of our guaranteed annuity rates is highly unlikely to exceed £50m". The cost most frequently reported internally, in and after September 1997, of providing for the annuity guarantees was £1.5 billion, which was the cost if the Society were liable to honour the guarantees on all in-force guaranteed annuity business. The lower figures made assumptions about take-up rates and about the validity of the Society's approach.

34. So far as reserving was concerned, Headdon argued that, as a starting point, any additional reserve held should "bear some relationship" to the commercial cost of the rates so far as the annuity guarantee rights were exercised, and that to require any greater sum would be inappropriate because, firstly, commentators would then assume that that was the commercial cost, and secondly, the policyholders would be protected by reserving for the realistic figure (indeed their future prospects might be harmed if offices were forced to reserve on an excessively prudent basis).

35. Although the regulators may have seemed supportive of the Society's stance on PRE and the use of the terminal bonus, and that was certainly the impression formed by management and reported to the Society's Board, they did not agree with Headdon's proposed approach to reserving. Hewitson sent a copy of Headdon's letter to Allen on 3 November 1998 along with a covering memo which made plain that GAD questioned his approach and set out the GAD position as follows:

> "We believe that appropriate mathematical reserves need to be established for the full value of these guaranteed benefits and associated obligations to policyholders in accordance with Part IX of the ICR 94, including in particular regulation 64. It is not acceptable in this context to regard these guarantees as covered by a 'first charge' against a final bonus for which no provision is made. This has clearly not yet been recognised by Equitable Life (and they have not even attempted as we requested at the meeting to quantify the reserves on this basis)."

He suggested that the Society should be written to urgently and invited in for a further meeting in the next few days. Roberts, to whom the letter was copied, commented on this in his evidence to the inquiry. When he had read the note:

> "... the issue struck me as being more serious than had been apparent before. As a result, I discussed it with Roger Allen and he wrote to Alan Nash on 5 November 1998 expressing our concerns about Equitable's reserving position in relation to the GAOs."

Allen's 5 November letter noted a "wide discrepancy" as between the views of the Society and those of HMT and GAD on the reserving issue. Having set out the regulators' view as per Hewitson's memo, he proposed an urgent meeting to discuss the matter and indeed, to discuss further the PRE issue.

[12] Having regard to Allen's maxwellisation representations, I should note that I have reproduced his comment more or less word for word as I am not able to reflect it otherwise.

36. On the same day Allen wrote again to Foot to fill him in on recent events and enclosed a copy of the draft guidance (in respect of which they had not yet received the response from the Economic Secretary). In the memo Allen noted that the Society's differential terminal bonus policy was "controversial", but that:

> "... our preliminary view is that [they are] entitled to do this, though we are seeking further information to test the position further. However, our primary concern is over the company's ability to reserve adequately for these guarantees. The information received to date is unconvincing and raises serious questions about the company's solvency. We shall be meeting the company next week to discuss what further steps we may require the company to take."

Foot's handwritten response indicated that he thought it critical that, as suggested above, further information be sought. In response to a suggestion that these exchanges showed that, from a very early stage in the unfolding crisis, the main focus for regulators was the Society's stance on reserving, as opposed to its stance on the differential terminal bonus policy and PRE, Allen explained in the course of his maxwellisation observations that the reserving issue was judged to be more questionable and more immediate, but that the PRE issue was still pursued. Roberts agreed. He noted that his memo of 6 November (see below) gave both aspects equal weight, and that both were addressed in the subsequent meeting. On PRE it was concluded that the regulators needed to do their own research, work that was only halted by the Society's decision to pursue the representative action. I consider that these representations should be accepted as explaining the emphasis in the steps that followed.

37. On 6 November (but seemingly before he received a copy of the 5 November memo enclosing the draft guidance) Roberts wrote to Allen about the conversation between them earlier in the week concerning the way forward with the Society. His memo noted that they had agreed to seek an urgent meeting with the company in order to be satisfied that they were taking a proper view of the liabilities that arose and PRE. Roberts commented:

> "This seems to me to cover not only the actuarial issues to which Mr Hewitson draws attention but also the question of whether the Equitable interpretation of the legal rights arising under these policies is one which the court would support... Our legal advisers will no doubt be able to express a view on the security of the Equitable's legal position, but it may be appropriate for us, if there is any doubt, to seek Counsel's opinion too."

38. On the same day the chairman of the FSA, Howard Davies, wrote to Roberts seeking answers to some questions he had recently been asked by a prominent academic economist. The questions raised were:

> "... first whether regulators should have taken an interest in the terms of these annuity contracts when they were sold. Is Equitable's view right that they could fund a guarantee shortfall by reducing bonuses, or is that inappropriate, and shouldn't regulators outlaw it? ...
>
> Then he wanted to know whether there was a failure of prudential supervision here if the fund could not bear the cost of these guarantees. Shouldn't our actuaries ensure that companies had funds available to cope with the guarantees, in a diverse set of economic circumstances?
>
> Then he asked what would happen if the funds were not available to pay up, except by reducing the size of the fund below a level which actuaries felt was required to deal with other policyholders' reasonable expectations. Would not regulators then be invited to pay Peter by robbing Paul, and how would those decisions be made?"

A handwritten note from Roberts to Allen suggested that they should consider these questions after the meeting with Equitable. Another note by the conduct of business

supervisors suggested that there was no need for them to get involved in this debate. But Davies' interrogator had identified serious issues for the Society and the regulators, and he had communicated those issues to the officers with the primary responsibility to answer them.

November 1998 Meeting

39. In advance of the meeting with Equitable (now scheduled for 13 November) GAD were asked by Allen to give some thought to what further information ought to be requested from the Society in order to make an assessment of its approach in terms of PRE. This prompted a list of "fundamental questions" by fax from GAD the day before the meeting:

> "1. When did the Board decide that different final bonus entitlements would apply if a policyholder elected to utilise the [annuity guarantee]?...
>
> 2. Has the company made the possible variation of final bonuses sufficiently clear to policyholders?
>
> 1998 W.P. Guide makes a passing reference only...; Note (2) in the [1995] Bonus Statement is very much "small print".
>
> Unless further evidence can be provided, it might be felt that previous policyholder expectations have not been adequately modified.
>
> 3. Was the tweaking of bonus policy, in relation to the introduction of a differential final bonus, in itself an action contrary to policyholders' reasonable expectations – that had previously been built on notices and statements solely referring to the build-up of a policy fund?
>
> 4. The letter of 30th October from Chris Headdon implies that policyholders who do not elect to take guaranteed annuity benefits are not given credit for the higher "Policy Annuity Value" forgone. How can this be justified in relation to the terms on which the contract was issued?"

GAD went on to suggest that the Society be asked to provide copies of relevant Board papers, communications with policyholders pre-1995 and any other documents which would support the differential terminal bonus policy and the required modification of previous expectations. The fax concluded with the following:

> "Even if the two-tier final bonus practice... were found to be acceptable, it would seem clear from the policy document already supplied that each policyholder is entitled to a "Policy Annuity Value" that is based on the guaranteed annuity available, whether or not they elect to take such guaranteed annuity. The company should be asked to confirm that such a minimum value is paid, notwithstanding the impression given in the letter from Mr Headdon... or, alternatively, should justify its current payment policy."

Hewitson had identified two critical factors: (a) the formation of policyholders' reasonable expectations; and (b) the possibility that alterations in practice might involve breach of established expectations. HMT now had notice of a difficult problem, namely the assessment of the impact of changes in approach on pre-existing policyholders' reasonable expectations.

40. The 13 November meeting was attended by Roberts, Allen and the two line supervisors; Robin Ford from the Treasury legal advisers; Hewitson; the scrutinising actuary from GAD, and Nash and Headdon from the Society. The minutes recorded that the regulators told the two directors that the differential terminal bonus policy was a "high profile industry issue" which HMT would need to fully assess. Further information would be needed from the Society properly to assess the PRE implications.

41. The directors replied that the Society had received legal advice that endorsed its position. They were also recorded as saying that there had been plans to

introduce the policy in 1993, but subsequent higher interest rates meant it was not in fact effected until 1995. According to the minutes, it was put to Nash and Headdon that press reports had alleged that projections to policyholders had shown the guarantee applied to unadjusted terminal bonus, with no mention of possible reductions of the guaranteed annuity rate applied. Nash responded by saying that, even if this were so, the level of terminal bonus had not been guaranteed.

42. Roberts proposed that HMT should select some random policy numbers from a list and inspect those documents. This would be preferable to a selection chosen by the Society, or to a site inspection, which could be very damaging if the nature of the inspection was leaked.

43. A specimen contract had been provided ahead of the meeting. Nash is recorded as rejecting an argument from GAD that the way the specimen contract was worded could be taken to mean that when an annuity guarantee was biting, any policyholder who opted for cash would be entitled to a larger cash fund so that this matched the value of the guarantee. He also stated that those policyholders taking the guaranteed annuity 'option' were still very much in the minority.

44. It was suggested to the Society that for reserving purposes it was necessary to reserve for what was payable under the contract rather than what option was chosen. Headdon thought this was "unrealistic" and "excessive". The regulators argued in return:

> "... that it was a statutory requirement to reserve on this basis and unless the Equitable could put up a compelling argument to the contrary we would expect the company to reserve on this basis."

Nash observed that timing was critical and that if the company were made to reserve on this basis "there would be severe commercial implications from low solvency cover which would have to be reported".

45. Nash and Headdon agreed to provide an update on the Society's free asset position. Headdon said he was convinced that the company remained solvent. But he also stated that thought was being given to seeking a section 68 order in respect of the resilience calculation, and to the need to reduce bonus declarations.

46. Following the meeting there appears to have been some discussions within GAD. A GAD memo dated 16 November 1998, which was copied to Allen, set out some points discussed that morning, and the result of a subsequent study of the specimen policy document provided before the meeting. The latter showed benefits payable at retirement as based on an 'accumulation value'. The Society was using differential accumulation values "depending on the option chosen by the policyholder". It must be appreciated, the note said, that the lower accumulation value, converted into an annuity at a guaranteed rate, could actually produce benefits of a greater value than the full value converted at the current rate. Provided alternative accumulation values were permissible, it was the author's view that the Society's practice was legally acceptable, and

> "Therefore, if the Society maintains its present practice, while it may lay itself open to policyholder complaints, I do not believe that HMT can raise objections on this particular aspect."

The proviso undermined the effectiveness and relevance of the advice: it was of little assistance for GAD to tell Allen that if the Society's practice were permissible, it would be legal. There were two issues: whether the practice was legal; and whether, if the practice were legal, it was permissible or excluded on grounds such as PRE.

47. The memo then observed that the differential terminal bonus policy had been mentioned in the returns for 1993, but that the first bonus notice to make reference to it was issued in 1996 (for the 1995 declaration). Although the author said it was "accepted" that the directors had absolute discretion, and "recognised" that the Society was keen not to give policyholders value in excess of their assets share, the memo observed that:

> "... it is still an open question as to whether the differential Accumulation Values are consistent with policyholder expectations. We suspect that neither original marketing literature or early bonus notices will have covered the possibility, so the Directors are totally relying on their general discretions to operate in this way and remain open to legal challenge."

There was nothing to add on the topic of reserving because "GAD is convinced that, to the extent that guaranteed benefits are available, full reserves should be carried".

48. That same day HMT wrote to Nash setting out the further information they wished to see following the meeting on 13 November, including a copy of counsel's opinion relied upon by the Society and an indication of its current financial position. Nash replied two days later acknowledging the request and stating that on the basis of draft figures the current surplus assets and implicit items were about £2bn (before any reserves for the guarantees).

49. The substantive reply followed on 23 November 1998, enclosing an opinion from counsel[13] dated 11 October and related documents. This opinion provided support for the legality of differential terminal bonus policy, but made some criticisms of the annual statements and suggested they be amended. The letter also enclosed a list of policies from which a selection could be made (as requested by Roberts at the meeting) and some figures said to illustrate situations in which the annuity guarantee would produce a higher retirement income, and those where it would not. Other information (in particular about reserving) was to be provided direct to GAD by Headdon.

50. This further information was provided in a letter dated the following day, with which was enclosed a copy of the latest internal management accounts. The letter was lengthy, and in essence sought to persuade GAD of the error of their position on reserving. The various calculations (as set out) demonstrated why most policyholders selected the cash option. It was asserted that the approach that the Society wished to take to reserving (ie realistic commercial cost) had been "tacitly accepted" by GAD since 1993. It was contended that there was no reason why the regulations required full reserving, as opposed to permitting prudent assumptions about the relative proportion of benefits taken in a particular form, and the auditors had agreed that the Companies Act accounts should show a provision for the guarantees which bore some relationship to their actual cost. The estimated form 9 position, before GAR reserving and without counting their implicit item of £850m, showed surplus assets of £1.2 billion and therefore "there is no question of basic solvency currently being in question".

51. If the Society was forced to hold onerous reserves they would have to consider the following choices: passing the bonus declaration, raising capital, using derivatives, publishing a form 9 where the RMM was only just covered, and making a sizeable switch to fixed interest. Having set out the difficulties with each of these options, Headdon said if there could be no agreement on the issue,

> "I shall need to consider what steps to take in terms of consulting with the profession, particularly since informal soundings indicate that I am not alone in my views on the interpretation of regulation 64."

52. By this time the HMT and GAD had received the negative reaction from the Economic Secretary to their draft guidance[14]. Hewitson sent a memo to HMT on 24 November to assist with a further draft letter. He suggested that it make various points:

> "1) As a starting point, we are suggesting that policyholders could reasonably expect to pay some 'premium' in advance for the guaranteed annuity option that they are given.

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[13] Brian Green QC.

[14] See paragraph 31 above.

2) For with-profit policies, this means that the accumulated premiums, less expenses and charges for the death benefit and the guaranteed annuity option, will be lower than for similar policies that do not contain this annuity option. Consequently, a lower final bonus, commensurate with this lower value of accumulated premiums less expenses and charges, may reasonably be offered on these contracts...

3) Under present investment conditions (with low yields on fixed-interest securities), there may of course now be a residual cost to the insurer of providing this guarantee, over and above the accumulated charges received over the duration of the contract.

4) In this scenario, we are suggesting that the cost should be met either from any 'orphan assets' (which are termed the 'estate' in this letter, as this expression is more commonly used by many insurers) or by the shareholders (6th and 7th paragraphs of the letter). This is though clearly a legitimate expense to be charged to the long-term fund.

5) Consequently, even more strongly than with pensions mis-selling costs, we consider that it is not possible to insist on shareholders meeting all the cost, and indeed the with-profit policyholders, as a whole, have generally financed a substantial part of the costs of writing this business. Indeed, for a mutual insurer, there can only be recourse to the 'orphan assets' or to with-profit policyholders. Generally, we have not suggested in the letter precisely how this cost should be attributed between with-profit policyholders and shareholders, in view of the difficulty in forming a judgement that would be fair and reasonable for all companies.

6) A particular difficulty arises for mutual insurers that do not have any 'orphan assets' or 'estate' and Equitable Life falls firmly into this category. In this situation, the ultimate residual cost of annuity guarantees falls to be met by either the policyholders who benefit from this guarantee or the remaining with-profit policyholders who share in the overall profits or losses for this business.

7) Unfortunately, Equitable Life has given these guarantees on a substantial portfolio of its policies (with an associated policy liability equal to around 40% of the value of all with-profit contracts). Consequently, the residual cost of the guarantee is relatively large and will necessarily impact the total amount of bonuses that can be paid to policyholders.

8) Contractually, it is arguable whether they are obliged to spread the cost more evenly across all their policyholders, and we are seeking more specific information from them in this context.

9) Nevertheless, the policyholders with these guarantees will have to meet at least part of the residual cost of these guarantees, even if this cost is shared across all policyholders. Moreover, the remaining policyholders will undoubtedly complain if their bonuses are now reduced on this account.

10) Our proposed letter does not prescribe the approach to be taken (which may properly differ between companies, according to their particular circumstances and policies) but seeks to set out the different considerations, leaving particular emphasis on the need to ensure that policyholders with these annuity guarantees are treated fairly."

The final paragraph reflected amendments proposed by Roger Allen.

53. The mixture of general and Equitable-specific comments in Hewitson's memo causes some difficulties in forming views on the advice tendered. The first and second paragraphs appear to be general in scope. In the case of Equitable they were wholly inconsistent with the realities, and they could not properly have been advanced. It is difficult to understand how any view could have been advanced without a great deal of detailed enquiry. However, on the basis that policyholders

could reasonably have expected to pay in advance for the guaranteed annuity 'option', Hewitson developed an approach to the allocation of distributable surplus that reflected the difference between business written with annuity guarantees and business written without.

54. That such an approach could have been taken at the outset does not appear to me to be in doubt. Opening a new bonus class for business that differed in the guarantees it offered for a given level of premium would not have been open to rational objection. But in 1988 the Society set out deliberately to sell personal pensions on the basis that identical premium bases were appropriate and that the bonus history of retirement annuity business could be relied on as directly applicable. The basis for the differential final bonus policy was already in place as a matter of executive decision. Thereafter identical bonuses were declared, and identical final bonuses were paid on claims until 1993-4. Hewitson's proposals could not be related to the reality of the Society's practice, and GAD had no basis in evidence or representation to think that they did.[15]

55. When asked about this note, Hewitson told the inquiry that:

> "I did not challenge [the senior line supervisor's] earlier assumptions that Equitable could adjust its terminal bonus as I had not seen the contracts in any level of detail myself and [the scrutinising actuary], who had looked at them, suggested in his note already copied to HMT that the approach was legally acceptable under the express terms of the contract, subject to alternative accumulation values being permissible, a point about which we had not come to a view. There was no fundamental problem seen with the differential terminal bonus as a concept provided that alternative accumulation values were permissible and that this was consistent with PRE."

I could not accept this as an appropriate response. The hypothesis that alternative accumulation values were permissible was fundamental, and no development of the advice was possible without resolving that issue. In response to maxwellisation, Hewitson has tendered the following explanation:

> "Paragraph 8 of my memorandum of 24 November 1998 to HMT specifically says that it was in my view debatable whether the Society was contractually obliged to spread the cost of the guarantees more widely than they proposed to do. They would have had to do this by reducing the overall bonus uniformly for all policyholders because the available surplus would be reduced as a result of meeting the cost of these guarantees. HMT was still seeking further information in this context, which was also relevant to the issue of whether Equitable's contracts entitled it to charge for the guaranteed annuity option, and if so, whether it could do so ex post facto. I therefore did not express any view to HMT at that time about whether Equitable was so entitled, nor did I suggest that the terms of their policies could be ignored. I simply was not in a position to address the issue at that time. In any event, ...it was normal (and I suggest, entirely appropriate) for HMT to take their own legal advice on such matters."

The attempt to separate GAD from HMT at this time may have been an accurate reflection of the formal position, but it did not reflect the reality that emerges from the contemporary record. The two bodies operated in a close relationship, and GAD was relied on for technical input at all levels. Identifying legal issues and distinguishing them from actuarial issues were matters in which each body played a part. Otherwise, I refer to the memorandum for its terms.

56. On 26 November Hewitson sent Allen a draft report entitled 'Effect of Current Market Conditions on UK Life Insurers'. Two days earlier GAD had written to all

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[15] In their maxwellisation representations, the Treasury suggest that other material, including the following paragraph, conflict with this last conclusion and shows that they did have some basis in evidence or representation for thinking as they did. I disagree.

appointed actuaries relaxing the resilience test. The draft report identified eight offices, Equitable being one, which ought to be called in to discuss their current financial position. The Society and one other company were identified as those causing most concern and as likely to be in need of some capital support were present conditions to continue. The report mooted the possibility that the Society would have to consider some form of demutualisation for which "there should be many willing partners". An update to the report which was also included commented:

> "Figures for Equitable Life at 30 October indicate that the company is just solvent assuming that 100% of policyholders exercise their GAOs... While this is reassuring it should be realised that publication of such a low solvency position is likely to severely undermine the company's reputation in the market and could threaten its survival as an independent entity."

Discussions were on-going on the appropriate reserving basis to be used and the acceptability of the approach to charging policyholders for the cost of annuity guarantees.

57. Having digested and considered the letters from Nash and Headdon of 23 and 24 November, GAD supplied HMT with two notes dated 1 December 1998; one written by Hewitson on the Society's reserving for the GARs, and the other by Rathbone on the PRE implications of the differential terminal bonus policy.

58. In the first, Hewitson responded to the various points raised in Headdon's letter, reiterated GAD's position on the need for full reserving and advised that the regulations did not permit the reduction of reserves on account of policyholder options. Hewitson went on to state that, as noted above, on the basis of the figures provided the Society would just have sufficient cover for the RMM after full reserving. He continued:

> "Whilst we recognise that this may not suit them commercially, we believe that this would place them on a consistent basis with other offices. It also indicates that they are very reliant on future surplus, largely arising from significant potential returns on equity investment, in order to fund their bonuses, including the discretionary final bonuses."

Under the final heading of 'Potential Action by Equitable' he stated:

> "They set out a number of possible short term options [in their letter]... It seems likely that they will need to consider some suitable combination of these for this current year-end. In particular it is difficult to see how they could justify declaring any bonus at this year-end.
>
> In the medium term, though, I believe that they will need to look for some ongoing form of capital support if they are to remain viable under difficult investment and trading conditions."

59. In his note on PRE, Rathbone pointed out that counsel's opinion did not provide total support for the Society's actions thus far, despite the reliance placed upon it at the 13 November meeting. He said that GAD agreed both with counsel's conclusion that the company had discretion to pursue the differential terminal bonus policy (subject to limitations in the contracts or statements made to policyholders), and with the advice that the Society's documentation to date had not adequately described the bonus methodology. The note also agreed with counsel's view that the company would have to establish the policy annuity value before the policyholder decided upon which option to take. Rathbone continued:

> "The question remains as to whether past vesting policyholders have been treated fairly, and Counsel advises that the Society ought to be able to defend its position in Court. *We do not feel sufficiently competent to offer an opinion on this legal question. The presentation adopted by the Society in its bonus notices... does not appear to have been in strict accordance with the policy conditions, but it is difficult to see how this might have created a breach of*

contract. It remains possible that policyholders could successfully argue that they were not led to expect a differential terminal bonus rate dependent upon the benefit they chose at vesting." [Italics in original denote GAD's view.]

60. As Rathbone's note acknowledged, GAD were not best qualified to consider legal and contractual problems. The files contain a draft memo, dated 2 December, from Ford, the Treasury legal adviser who had been present at 13 November meeting. On the question of full reserving and regulation 64, the draft memo said:

> "[Regulation 64] sets out an objective standard. In other words, it is not for HMT to decide whether liabilities have been properly determined, but for a Court. There is clearly room for more than one reasonable view as to "proper provision" and "prudent assumptions". Having said that, it seems to me that any entity which adopts the GAD/HMT view on reserving would be within reg 64. What is not so clear is whether Equitable Life's view is in breach of reg 64. If Equitable is not in breach, I am not clear on what basis HMT might take action against it."

The draft memo went on to suggest as an initial view that HMT would bear the burden of proving the breach.

> "Only where Equitable could be shown to be significantly out of sinc (*sic*) with accepted practice or clearly acting unreasonably would the onus fall on it as a matter of fact to demonstrate compliance."

Ford had also been asked to provide her views on counsel's opinion about the differential terminal bonus policy. As far as contractual legality was concerned, the draft memo suggests that Ford did not take issue with the conclusions in the opinion. It went on to say:

> "However I understand it to be your view that considerations of PRE may go beyond determining what is a legally acceptable construction of the contract or exercise of discretion under or in conjunction with the contract. If so, then Mr Green's opinions (even if you accept them) are not an end to the matter. You will still wish to make your own examination of the documents, events and policyholders' representations to come to your own views on PRE."

At this stage there does not appear to have been settled legal advice available internally, and the draft advice that was available was evidently based on incomplete data.

<u>3 December 1998 Meeting with the Society</u>

61. On 3 December there was a further meeting with the Society. Attendees were as for the 13 November meeting, except that Rathbone attended in place of Hewitson. The minutes recorded that HMT announced that their position on reserving was unchanged from the previous meeting, i.e. the Society had to reserve for all guaranteed benefits under the contracts.

62. Headdon defended the Society's stance and argued that their reserving methodology was not new and that GAD should have been aware from the returns that they were writing business with annuity guarantees. The allegation of tacit acceptance of the reserving basis was repeated (as in his letter of 24 November). GAD rejected this, stating that whilst they were aware that annuity guarantee business had been written, it was not possible to tell from the return the construction of the contracts adopted by the Society, nor the reserving basis applied.

63. In response to the Society's argument that the HMT position was excessively prudent and unrealistic, HMT argued that there was the possibility that those policyholders who argued that they should be paid a GAR on unadjusted terminal bonus could win their case, which would require even higher reserves. Nash accepted that there was at least a potential contingent liability. Allen indicated that he could not see any scope for a concession, that appropriate measures would be

taken to ensure compliance and that the Society's only appeal route was by way of judicial review. Nash said that they might well have to take that course.

64. GAD then expressed the view that if the Society had not been mistaken in its interpretation of the regulations, it would not have made the bonus declarations it had. The minutes noted that:

> "Questions were also raised regarding the prudence of trying to operate without an estate."

GAD pointed out that a fair proportion of the previous year's reversionary bonus had been paid out of "asset value gains". In response:

> "Mr Headdon argued that since 1986 reversionary bonus rates have been managed down although he did admit that it was possible that there had been times when the value of the accumulated policyholders' asset shares had been greater than Equitable's assets. Nevertheless he argued that he did not believe that it was in the interests of policyholders for the Equitable to build up a large estate."

The statement was not entirely new: regulators had known for some considerable time that the Society's advertised policy was one of full distribution. However, on the information communicated by the Society, the regulators would not have been in a position to challenge the statement that since 1986 "there had been times" when aggregate policyholders' asset shares exceeded the Society's assets. There had in fact been no year-end at which that had not been the case.

65. The Society confirmed that they had not taken legal advice on the reserving issue. Headdon observed that the Society could take the reserving hit this year, but with severe consequences. A decision had not yet been made about the 1998 bonus. He confirmed that reinsurance had been considered as an option for protecting the balance sheet. However, he was reluctant to "broadcast" the Society's position to potential reinsurers at that point in time, and if cover was purchased, it was unlikely to be in place for the current year. HMT indicated that it would be possible to give a concession so that the effect of any treaty was post-dated to cover the 1998 year-end position.

66. Headdon reiterated his view that the Treasury stance was excessively prudent and that he might have to consult with the profession (as per his 24 November letter).

67. The minutes then record that the regulators:

> "... explained that we had still some way to go before coming to a conclusion on PRE... HMT considered that if the advice given by Counsel... was followed in relation to the revision of annual statements there would be relatively little doubt that PRE would in future be met."[16]

HMT said that they wished to consider this issue further so far as policies which had already matured were concerned. Some further information was requested. It is far from clear what was meant by the comfort offered relative to counsel's opinion. In particular it was not explained whether it was thought that adopting the formulation proposed by counsel for bonus statements would affect future PRE in respect of future contributions, or would have retrospective effect on previously formulated reasonable expectations, affecting all in-force business. As noted above possible difficulties with attempts at rewriting policyholders' reasonable expectations had already been identified.

68. The next day Ford sent HMT a further and fuller interim version of the advice previously provided. It was made clear that it was not intended to be final or complete legal advice: that was not yet possible. Further argument was awaited from

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[16] This was a reference to Green's advice set out in chapter 1 at paragraph 49.

Equitable. This advice went further in addressing the Society's stance on reserving and suggested that:

> "... I think on balance that a Court would accept that Equitable's position is untenable (even though supported by its actuary). I am not convinced, however, that a Court would accept that reg 64(2) requires that prospective liabilities be 100% reserved. The Court is likely, however, to accept that 100% (or thereabouts) is required in this case, if Equitable continues to maintain its position at the low end."

The advice went on to consider what action could be taken if the Society did not comply. Ford had already been told that HMT preferred to act under section 45 on the grounds of a failure in sound and prudent management. She advised that, if the Society were in breach of the regulations (which she suggested they were or would be),

> "... such intervention is unlikely to be successfully challenged in the Courts as long as its terms are not Wednesbury unreasonable."

The thrust of the advice had developed. At this stage regulators had a limited degree of comfort, albeit qualified, that if their conduct was not unreasonable according to the *Wednesbury* criteria[17], it was unlikely to be amenable to judicial review.

69. On 7 December 1998 Allen wrote to Nash to summarise the points from the 3 December meeting. He said that HMT and GAD required

> "... reserves... at or very close to 100% of the value of the minimum guaranteed benefit",

and he firmly rejected the Society's position that it was prudent to assume that only 25-35% would not opt to take the cash option. On the subject of reinsurance, Allen confirmed that HMT would be willing to treat any arrangement as having been effective from year-end,

> "... provided that at least the broad terms... were in place by that date and a firm intention to enter into the agreement could be shown."

On the subject of PRE, Allen noted that further information had been requested from the Society in order to allow a firmer view to be reached. The letter ended by saying:

> "We also indicated that we expected an appropriate statement on contingent liabilities to appear in your regulatory returns, related to the risk [of] successful challenge to the Equitable Life's bonus practice with regard to guaranteed annuities."

70. Allen's letter of 7 December to Nash referred to further advice regulators had received from GAD. This appears to be a reference to discussion between Allen and Rathbone about reserving which had taken place that day and which the latter set down in writing to HMT the next day. Rathbone's note set out GAD's view of the valuation basis formula for contracts containing guaranteed annuity provisions. He noted that GAD would have no objection to the Society phasing in this formula (provided they could restrict the period and full disclosure of the basis was made in the returns) and recommended that HMT obtained a commitment to reduce reversionary bonus for the contracts until full provision had been made. Rathbone also took the opportunity to counter the suggestion that the reserving basis had been disclosed in previous returns and went on to suggest that the paucity of information given therein might lead to Headdon being censured (in respect of 1997 returns). Finally Rathbone suggested that it might be appropriate for Headdon to speak directly with the Government Actuary, Chris Daykin.

71. On 9 December further advice was submitted to the Economic Secretary along with a revised draft of the guidance letter, which drew on Hewitson's suggestions in

[17] See glossary.

his 24 November note. On 15 December the Minister indicated that she was content for the guidance to be issued.

72. In the meantime Nash had telephoned Allen on 10 December in response to his letter. According to Allen's note of the conversation, Nash indicated that the Society still did not accept the HMT/GAD position on reserving, and said that they had now received favourable legal advice about their own position and were seeking Counsel' s opinion. He then said he would be in touch once the latter had been considered, but noted that, failing any agreement, the Society was prepared to judicially review HMT. Nash also stated that they had approached two insurers about the possibility of reinsurance.

73. Whether prompted by this call or not, Allen asked Ford some questions about HMT's powers that day and received her response the following day. Ford advised that a breach of the accounts and statements regulations would seem to be a strict liability offence, but questioned whether HMT could oblige a company to reissue or amend the accounts. A few days later Rathbone wrote to Ford expressing surprise about her conclusion on reissuing and expressing GAD's view that there was a power to require "reproduction" of the abstract of the actuary's report and resubmission of the returns. Ford responded on 31 December clarifying her view, which was that there was no power to require reissue or amendment of the accounts per se, and that she doubted in the circumstances that powers under section 45 could be used because it was not clear that such an action was an appropriate remedy to ensure sound and prudent management or protect policyholders. She also advised that there was no power under section 18 of the 1982 Act to require reproduction of the abstract or resubmission of the returns.

Briefing Meeting between HMT and FSA

74. As of 1 January 1999 the FSA took over from HMT the practical implementation of most of the prudential regulator's functions. As part of the handover there was a briefing meeting about the Society on 15 December 1998 between Davies and Foot of the FSA and Roberts and the senior line supervisor from HMT. In advance of the meeting a note had been prepared summarising the current situation. The note made the following points:

i. Financial position (as at end October 1998)

a. The company was described as "just solvent" if it reserved fully (a cover of 1.24x). This included no bonuses allowance for which the company appeared to have insufficient assets (assuming a cost comparable to the previous year).

b. £850m of the £1.1 billion of available assets derived from future profits. The Society was close to breaching the requirement that only 5/6 of the RMM could be covered by implicit items. It was said that a relatively small fall in equities or gilt yields could wipe out the company's explicit free assets. (The regulators had known that the Society was vulnerable.)

ii. Strategy for regulatory action

It was noted that there was to be a further meeting with the Society before Christmas which would be used to:

a. Indicate that HMT would not take action against the Society for failure to reserve fully for annuity guarantees in its 1997 returns (as was the case with all companies).

b. Formally put the Society on notice that its approach to reserving at 25-35% was not acceptable.

c. Indicate that in settling its year-end position in its 1998 returns it was for Equitable to decide the reserving approach to adopt since it was for the company to comply with the Regulations. But the

Society would be made aware that if in the FSA's view the returns were not compliant FSA would take action.

d. Seek an undertaking from the Society that it would not declare any further bonuses without prior discussion with HMT. If necessary the threat of intervention on the grounds of sound and prudent management could be used to secure their agreement to such a course.

iii. Timing of any intervention action

a. The note explained that intervention would be likely to take the form of closing the company to new business.

b. If the company refused to agree to prior discussion with HMT before making a bonus declaration, intervention would have to be immediate.

c. If the company did agree, intervention would only be necessary when the Society intimated an intention to declare a bonus which would cause a breach of the RMM if there were full reserving.

d. If the company declared no bonus, there would probably be no need to intervene unless the 1998 returns (submitted in June 1999) made it clear that full reserves had not been established.

e. It was expected that Equitable would seek judicial review of any intervention action taken in relation to its approach to reserving for annuity guarantees.

iv. Other regulatory action to be taken

a. The policyholder documentation provided would be analysed in December and January in order to reach a view on whether the differential terminal bonus policy was consistent with PRE in the case of maturing policies.

b. In January there would be a 'dear director' letter about reserving.

75. According to the minutes of the meeting, Foot asked why no action had been taken on the basis of the returns and was told that the Society's approach had not been clear from the returns. The acceptability of the differential terminal bonus policy was then discussed and the minutes recorded that:

> "HMT had seen the Counsel's opinion obtained by the company; this provided reasonable comfort that the approach was consistent with PRE. However, HMT had specified a list of further documentation that it wished to see in order to make its own assessment on this point."

In fact the opinion did not deal with PRE, an inaccuracy in the minutes commented on already in the Baird Report[18].

76. On reserving, it was noted that HMT had had discussions with "a number of companies and in each case they had accepted the view that GAOs must be fully reserved", though "some had accepted this view more reluctantly than others". Foot observed that any level below 100% would be arbitrary, although he was assured that there were good reasons for GAD's position of a slight relaxation to 97.5%. Comfort was also taken from the fact that if Equitable reserved on a 100% basis the company's financial position could not be made worse if it had to abandon the differential terminal bonus policy.

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[18] 'Report of the FSA on the Review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000, which HM Government is submitting as Evidence to the Inquiry conducted by Lord Penrose', 16 October 2001. The comment is on page 98, at paragraph 4.19.9(b).

77. The possibility that the Society might fail to declare a bonus was described by Davies as "commercial suicide" on the ground that no independent financial adviser would subsequently recommend its products. It was noted that it was not yet clear that it would be necessary for no bonus to be declared, but that:

> "From HMT's perspective it was vital that the company was not permitted to make itself insolvent... by declaring further bonuses."

The possibility of judicial review on the reserving issue was also discussed. The minutes record that it was felt that a move to prevent a bonus declaration could be justified on the basis of sound and prudent management and should fall outside the immediate scope of any judicial review. The minutes ended:

> "It was concluded that situation was not a happy one but in the circumstances HMT appeared to be taking the only sensible approach."

78. A few days after the meeting the scrutinising actuary wrote to comment on the minutes. He commented that it was not correct to say that no action had been taken on 1997 returns since the current discussions had resulted directly from enquiries about them, and he reminded HMT of the 28 May 1998 meeting at which issues about both reserving and PRE had been raised. He also challenged Davies' comment about commercial suicide, explaining that the Society did not depend on IFAs, and said:

> "GAD does not believe that it would necessarily amount to commercial suicide if no additional guaranteed bonuses were granted this year in relation to contracts containing GAOs, provided the reasons were properly explained to policyholders - indeed we consider that such a step is probably necessary for the prudent management of the Society."

Singling out the 'contracts containing GAOs' for adverse treatment in relation to reversionary bonuses in addition to the differential final bonus scheme would have been difficult to explain to those affected. GAD's approach over this period seems to me to have been persistently naive.

79. While HMT continued to assess the Society's differential terminal bonus policy, the public line taken on it would have been viewed as supportive. This was illustrated by a letter sent to an Equitable policyholder on 16 December 1998. Part of the letter read as follows:

> "Clearly at maturity insurers are required to meet the costs of any benefits which have been guaranteed to policyholders up to that point. However, these guaranteed benefits do not normally extend to the discretionary final bonus that may be payable. Consequently, a number of insurers, including Equitable Life, consider that the level of this discretionary bonus may be adjusted to ensure fairness between the different classes and generations of policyholders.
>
> The adjustment is particularly relevant for mutual insurers that, as a matter of policy, do not seek to build up large amounts of retained surplus, but rather intend to provide to each group of with-profits policyholders with benefits that are broadly commensurate with the accumulated premiums received from that same group... It would be very difficult for such insurers to provide additional amounts of discretionary bonus beyond the value of these accumulated premiums without prejudicing the interests of other members.
>
> Within this overall framework, we believe that as prudential regulators of the insurance industry the Treasury is treating all mutual insurers in a similar manner."

The writer may have been trying to be neutral. Those responding on behalf of the Treasury to maxwellisation maintain that it was neutral. But from the point of view of the recipient, it is my view that the letter read as quite unequivocally supportive of the policies pursued by insurers generally, and the Society in particular, at this time.

The Annuity Guarantee Guidance Issues

80. Having received ministerial approval, Roberts circulated the final version of the proposed guidance note on the PRE aspects of the annuity guarantee issue to Foot and HMT. Roberts commented in his note:

> "... commentators are likely to see it as relating primarily to the Equitable. Some will see it as support for the Equitable's position; some will see it as a shot across their bows."

I think it is doubtful whether many in the wider community would have had the insight necessary to identify the letter as a warning shot. Roberts does not accept this view and argues that, as the Society were on notice that HMT were not satisfied that their bonus practice was consistent with PRE, the warning would have been clear to the Society at least.

81. The guidance was issued to all managing directors the next day, 18 December 1998. The purpose of the letter was said to be:

> "... to provide some guidance to companies on the Treasury's interpretation of PRE [in the context of GAOs]."

What followed was in effect a rehearsal of the content of Hewitson's 9 October memo, with some strengthening of the reference to the contractual position, namely:

i. as a starting point, policyholders could be expected to pay some charge or premium towards the cost of the guarantee;

ii. meeting this cost could in some cases be met by a reduction in terminal bonus;

iii. this would depend on the wording of the contract and how it had been presented to policyholders; and

iv. the appropriateness of adjustments to bonus allocations would need to be assessed by each office in the context of PRE. This assessment would be influenced by the policy documents, marketing literature, bonus statements and any other documentation through which representations had been made to policyholders.

82. Roberts has told the inquiry that the guidance was neutral on the Society's position:

> "... I do not think that the guidance we issued on GAOs was incompatible with the House of Lords decision, nor with the 'ring-fencing' approach or indeed with Equitable's approach. We did not express any view in the guidance on Equitable's practice. Instead the guidance was largely confined to setting out the issues to be considered in handling the GAOs."

While I have no doubt that this accurately reflected the intention of regulators, it illustrated the dangers inherent in statements intended to be neutral, but which lend themselves to misinterpretation by those representing the extremes of opinion on all sides. The completely understandable reaction of some of those who saw it was that it expressed support for the differential terminal bonus policy. On 22 December Denton Hall, the Society's solicitors, wrote to the PIA Ombudsman about GAO complaints and made this unqualified observation:

> "In the meantime, we attach a copy of a letter dated 18 December from HM Treasury to the Managing Directors of all [long term insurance business] companies... The letter supports the Society's stance in relation to GARs."

Denton Hall were not alone. In the Court of Appeal judgment Morritt LJ (dissenting) stated the following:

> "... it is not irrelevant to observe that the [differential terminal bonus policy]... has been approved or emulated by others. Thus the relevant official in HM Treasury... in writing on 18 December 1998... envisaged that depending on the

> terms of the contract it might be possible to award a lower final bonus in respect of contracts containing a guaranteed annuity rate when compared with contracts which did not..."

22 December 1998 Meeting with the Society

83. The issue of reserving still remained contentious . On 18 December Nash sent HMT a copy of Counsel's advice on the subject (as foreshadowed in the 10 December phone call with Allen). Nash provided this in advance of a further meeting scheduled for 22 December, at which he hoped there could be a "mutually satisfactory outcome". The tone of the opinion provided strong support for the Society. The regulators' approach to reserving was portrayed as inconsistent, prejudicial, wrong in law, invalid, extreme and amenable to judicial review. In short Counsel supported a reserving level "very substantially below... 100%".

84. Despite the issuing of the guidance note, the differential terminal bonus policy was still very much a live topic for discussion, and Nash took the opportunity in this letter to make what was to be a very important announcement:

> "On the advice of Leading Counsel the Society has decided to take one or more test cases to the High Court in order to confirm that the Society's Directors have acted entirely properly and within their powers in adopting the system of final bonus additions... Although not directly pertinent to our current discussions, I hope that you will regard this action as a demonstration of the Society's confidence in its position and its determination to maintain it for the future."

In the light of the legal advice they had received, and the perception of the official position they shared by with their legal advisers, the Society was at this stage in an assertive mood.

85. At the 22 December 1998 meeting the hoped-for "mutually satisfactory outcome" did not materialise. The minutes recorded that HMT said they had not had time to examine the papers in detail and would send a written response to the opinion, but agreed to discuss the matters raised on a 'without prejudice' basis. Allen stressed that it was for the Society to reserve how they saw fit, but that HMT would take regulatory action if the reserves disclosed in the returns were inappropriate, or if the company's actions imperilled solvency cover. Action would also be taken if the Society declared bonuses at a level HMT considered imprudent. Headdon said they did not want the uncertainty of regulatory action hanging over the Society and thought it best to resolve the position earlier. Nash agreed to liaise with HMT prior to deciding a bonus strategy (the decision usually being finalised in February).

86. In relation to the opinion from counsel, HMT pointed out that it did not address the point that the existence of the guarantee influenced consumer choice and that the value of the cash option would have to be sustained at the level of the guaranteed annuity. GAD rejected the criticism in the opinion that they had tacitly accepted the company's reserving practice. Headdon and Nash reiterated their arguments in favour of their approach, and argued that the level of reserving required by HMT was excessive. It would seriously constrain investment strategy and threaten the Society's future:

> "Mr Nash believed that the combination of these factors could put immense pressure on the company to find a buyer. Mr Nash agreed to write to us further on the consequences of taking this reserve hit as we had some difficulty in accepting all of his arguments.".

Headdon did not guarantee that they would not pay further bonuses to policyholders with annuity guarantees. The minutes noted that:

> "There was no agreement between HMT and the company on the fundamentals of the argument. Mr Nash argued that [the] approach taken by HMT was not in the interests of policyholders. Mr Allen stressed that we did not want

> policyholders or potential [policyholders] to be misled or disadvantaged by the company mis-reporting its financial position in the annual returns."

However Allen said that HMT understood the potential for policyholders to be adversely affected by a "sudden hit of this magnitude". He was willing to help the company soften the blow and indicated that HMT would view sympathetically an application for a larger implicit item, and would consider certain transitional measures which differentiated between those policyholders close to retirement and those not. Headdon confirmed that reinsurance was still being actively considered.

87. Allen said that a 'dear director' letter on reserving would be issued early in January 1999.

88. On the same day, no doubt encouraged by what had been said at the meeting, Headdon applied for a future profits implicit item of £1.9 billion. The application was expedited. It was approved by GAD the next day and issued on 30 December.

89. On 31 December, Ford provided Allen with a draft of a written response to the opinion, which had been promised at the meeting. The draft explained that the opinion had not caused HMT to change its stance (failing as it did to address the material points) and rebutted any suggestion that the Society had put the regulators on notice of their practice. The draft repeated the offer of short-term assistance. On the same day Nash wrote to Allen chasing him for the written response to the opinion and notifying him that they had received an offer of reinsurance. A fax from the reinsurers was provided as evidence of the intention to provide cover.

90. Hewitson (who had not been present at the meeting) entered the debate about counsel's opinion on the 4 January 1999. He argued that counsel's approach to the take-up rate was essentially flawed because it failed to take account of the fact that if the value of the guaranteed annuity was higher, more policyholders would opt for that benefit. The Society could not properly rely on recent experience because they had offered policyholders an additional discretionary cash sum if they chose the cash benefit. Hewitson also thought that counsel's interpretation of some of the regulations was incorrect. On the issue of prior disclosure, Hewitson observed:

> "... I accept with hindsight that we might have addressed the issue rather earlier by asking some pointed questions about their guaranteed annuities. However, the presentation of the valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the return and draw certain inferences from them. There was nothing to indicate that the level or extent of these guaranteed annuities were regarded as significant."

Hewitson set out three action points:

i. inform the Society in writing that the level of reserves in 1997 returns were not satisfactory;

ii. respond to Counsel's opinion; and

iii. obtain further information from the Society to enable a better view to be formed about its current financial condition, including:

    a. information about aggregate asset shares and total mathematical reserves as at end 1998, and

    b. a copy of the most recent financial condition report.

The FSA Period Begins

The Reserving Guidance

91. On 7 January Roberts sent advice to Davies on the proposed guidance on reserving. He described the reserving issue as "the main area of dispute with Equitable Life" and explained that it was proposed that there should be a general

letter to all appointed actuaries from the Government Actuary, a letter from FSA (by now acting on behalf of the prudential regulator) to all managing directors for emphasis, and a bespoke letter to the Society. Rather than ask affected companies to resubmit their 1997 returns, they would be asked to submit their 1998 returns early. Roberts explained this in the advice:

> "We are clear that action to prosecute the companies for supplying improper returns would be a disproportionate response and in any event very unlikely to succeed. We have considered the options available in terms of other intervention action, none of which is attractive, and concluded that the least bad approach is to ask those companies whose 1997 returns were not prepared in accordance with the guidance, and would have shown a materially different financial position if they had been so prepared, to accelerate submission of their 1998 returns."

In his analysis of the pros and cons of taking no action on the 1997 returns, Roberts acknowledged that this would leave FSA in a "very difficult position" as regards arguments that policyholders would have been misled by the returns, but he argued against this that the time frame was short, and that in those cases where the impact would have been significant either there had since been a capital injection, or a reinsurance arrangement, the company had been closed to new business, or was already classified as weak in any event. The approach was approved by Davies.

92. The bespoke letter to the Society was sent by Allen on 11 January. The content largely followed Hewitson's suggestions and made it plain that FSA would not change its position as a result of the legal opinion. In the short term an offer was made to try to mitigate the effect of full reserving providing certain conditions were satisfied.

93. The 'dear managing director' and 'dear appointed actuary' letters were dated 13 January 1999. The first, which enclosed a copy of the second, reminded managing directors that it was they who bore the ultimate responsibility for establishing proper reserves. It then explained that where 1997 returns had not been prepared in accordance with the enclosed guidance and this had had a material effect upon the company's financial position, FSA thought it "appropriate" for 1998 returns to be submitted early and by no later than 31 March.

94. The essence of the guidance to appointed actuaries was:

> "In general it would not in my view be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them, although some limited allowance (of a few percentage points of the reserve) could in some cases be made for a reduction in the liability on the grounds of the additional flexibility or other perceived advantages to policyholders of any alternative benefits... any reductions in the reserves held... by more than a few percentage points below the full value of the guaranteed annuity... would require very careful justification by the actuary."

Appointed actuaries were asked to ensure that the returns contained sufficient information to allow FSA and GAD to make an assessment of:

i. the extent of the guarantees offered;

ii. the reserving basis; and

iii. the scope for the guarantees to impact upon the financial position of the company.

95. The meaning of "a few percentage points" was to become a source of debate. Chamberlain has told the inquiry that he wrote the guidance document, but explained:

> "I drafted the guidance on reserving for GAOs but others in GAD added the "few % points" allowance for discounting for less than full take-up as a compromise. They expected such discounts to be less than 10% and ultimately

> limited them to be less or equal to 5%. I was one of several who thought 100% was the proper reserve with any failure of policyholders to take up the options counting towards surplus."

The following day the FSA issued a press notice which announced the request for the submission of early returns, but did not name the individual companies concerned.

96. It is of note that at about this time in mid-January the Society was writing to policyholders explaining the decision to initiate the court case. The regulators had been told of this decision on 18 December, but had not been informed of the Society's intention to write to policyholders, nor of the terms of the explanatory letter. The letter to policyholders appears to have come to FSA's attention only because a member of staff was a policyholder and brought his copy to his colleagues' attention.

<u>The 1998 Bonus Announcement</u>

97. Guidance having now been issued both on the differential terminal bonus policy and reserving, FSA turned its attention to the Society's bonus announcement. Allen wrote to Nash on 18 January requesting the further information listed in Hewitson's 4 January note. Nash's reply of 21 January promised that all but one of the items would be supplied within a few days. The outstanding item was the financial condition report of which Nash said:

> "... since our Appointed Actuary has always been fully involved in all Board and Investment Committee meetings, we have taken the view to date that Financial Condition Reporting is most usefully dealt with as a continuing process throughout the year, rather than being covered in a single annual report."

Nash enclosed examples of the main types of documents that contributed to this continuing process in 1998, including annual financial projections and monthly financial reporting figures. The financial projection paper was dated February 1998, before the GAR issue had blown up, but other documents were more recent. Draft terms of the reinsurance agreement were also enclosed. The agreement, which was effective from 31 December 1998, was said to enable the Society "to reserve at a level which we feel prudently reflects our likely future experience".

98. So far as the bonus declaration was concerned, Nash stated that the directors' initial view was that there ought to be a "substantial reduction" from 1997 (when there had been a total growth rate of 13% made up of the 3½% GIR, 3% reversionary bonus and 6½% terminal bonus).

99. Allen replied on 26 January accepting the explanation for the lack of a single financial condition report, but asking for further papers to be supplied about bonus recommendations made to the Board and the appointed actuary's valuation for the end of 1997. Reference was also made to an upcoming meeting about reinsurance. On the same day Headdon sent the outstanding information requested in Allen's 18 January letter. Headdon's reply set out the mathematical reserves and aggregate asset shares figures, giving the "aggregate smoothed asset share" as 103% of the assets attributable to the with-profits business. Other figures suggest that the excess of aggregate with profits policy values over assets in fact stood at 105.4%[19] for 1998 year-end. Smoothed assets shares, as computed by the Society, took account of values that were not reflected in financial statements or in the office valuation, the 'aspirational assets' identified in earlier discussions between GAD and the Society.

100. The PRE implications of the Society's documents relative to the introduction of the differential terminal bonus policy also remained outstanding following the issuing of the guidance. The issue became prominent in late January 1999 as a

[19] See chapter 6.

result of a request from an MP for guidance on PRE on behalf of a constituent who was an Equitable policyholder. Ford asked Roberts whether consideration of the PRE issue by FSA was active and ongoing, or whether it was to be or had been postponed until after the court case. She advised that FSA could properly consider the issue without waiting for a decision by the court (although any decision on the contractual or trust issues would need to be left to the court), but that policyholders would have to be consulted as part of the assessment. In support of this, she pointed out that the assessment to date had been based solely on material supplied by the Society, whereas regulators were concerned with the PRE issue because complaints had been made.

101. Regulators had not actively monitored PRE as a routine aspect of the regulatory cycle. The emphasis on getting input from policyholders was proposed without an established policy or practice of canvassing policyholders.

102. Allen responded to Ford's email as follows:

> "As a matter of policy, my strong preference is not to reach a decision on PRE until after the court case. (I understand that the court decision will not in principle preclude FSA taking a view whether or not to intervene on PRE grounds; but in practice, the judgement as to whether PRE has been met or not will depend crucially on the precise nature of the individual contracts, as well as what policyholders were told; so that it would be sensible to await the court's decision on the legal position.)"

The senior line supervisor agreed, but added that FSA should "do some of the ground work in the interim". Allen reflected the orthodox view that a decision on PRE would depend on what had been provided to policyholders, if it had to be considered following the decision in *Hyman*. A decision to defer consideration of PRE was made in later January, and the issue was not resurrected until just before the court hearing commenced in July 1999.

<u>28 January 1999 Meeting</u>

103. At the end of January 1999 the reinsurance treaty was also under discussion, in particular at a meeting with the Society on 28 January arranged to discuss the subject. Rathbone sent a memo to Allen, on the day before the meeting, with GAD's assessment of the terms provided under cover of Nash's letter of 21 January. Rathbone explained that the reinsurance treaty was a financial arrangement, the intention of which was simply to enable the Society to maintain a reserve equivalent to providing for 25% of the potential cost. GAD had identified a number of flaws in the agreement:

i. in the way it defined the annuity guarantee costs covered;

ii. in permitting cancellation by either party retrospectively, with the Society to pay any outstanding amounts immediately; and

iii. by limiting total withheld claims to £100m as at 31 December, subject to restructuring of the agreement.

According to the FSA minutes of the meeting, Headdon accepted the points made, but observed that the intention behind the £100m limit had been to provide a right to review. Should no agreement be reached, he explained, the intention was that agreement would continue unchanged. He would see if the terms could be clarified. The Society would also look to reduce the circumstances in which the agreement could be cancelled. Headdon's notes of the meeting record his view that the regulators "broadly accepted the £100m renegotiation point, but felt that there should be some clarification of the scope of the renegotiation".

104. At this meeting Headdon handed over a further document on bonuses and valuation that had been requested in Allen's 26 January letter. The document provided was a board paper by Headdon entitled 'Valuation and Bonus Declarations as at 31 December 1998'. The paper was dated 22 January 1999 (i.e. post guidance

on reserving), and it noted that the background was one of significant uncertainty. He referred in particular to the recent guidance and the possibility of reinsurance. In the paper Headdon argued that:

i. the extent of the GAR take up was extremely low and thus the commercial cost of meeting the additional benefits was also very low;

ii. even if further changes in financial conditions made the GARs more attractive, it was unlikely that "more than a small proportion" of benefits would be taken in this form;

iii. therefore there was no need to change the estimate that the commercial cost of the GARs was unlikely to exceed £50m.

It was Headdon's view that a prudent reserve would be on the basis of a 25% take-up, and he said that:

> "In the absence of regulatory pressure to do otherwise, that is the level of reserving I should establish in the statutory returns. It is also the level of reserving the financial reassurance arrangements currently being negotiated are intended to facilitate."

The Board was told that the level of reserving required under the recent FSA guidance was excessive:

> "The guidance is not mandatory but there is a clear message that any office not complying with it risks regulatory action. The guidance leaves some limited room for discretion and there is an issue as to how far the discretion can be pushed without incurring the displeasure of the regulator... my current assessment is that the lowest proportions of benefits we could assume taken in GAR form without being held to contravene the guidance are 65% in the case of retirement annuities, 75% in the case of individual pensions and 80% in the case of group pensions."

The view of the executive was that a rate of 5% (6½% for 1997) should be declared for bonuses (made up of the 3½% GIR and 1½% reversionary). If reserves were set at the 25% take-up level and with the benefit of reinsurance the RMM would be 2.5x, and at the 65-80% take-up level without reinsurance the RMM would be 1.1x (although this could be bolstered by utilising a larger future profits item). An overall growth rate of 10% was recommended (implying a terminal bonus of 5%).

105. A 10% overall allotment, allocated equally to contractual and final bonus resulted in balance of reversionary to terminal bonus at an all time extreme ratio of 23/77. Moreover, Headdon's interpretation of "a few % points" was revealed to be 20-35%. The scrutinising actuary phoned Headdon the next day, 29 January, to discuss his justification for the 65-80% figures. In his note of the conversation, he observed that:

> "Mr Headdon was, in truth, rather vague as to how he justified the percentages of total liabilities for which he assumed retirement benefits were taken in GAR form."

He noted that some of Headdon's explanations did not reflect his own understanding of how any supposed flexibility was to operate. He reported that he had explained:

> "... that these adjustments would require further discussion before he could expect the supervisor to accept them as producing acceptable prudent reserves ...
>
> [Headdon] seemed to be gradually accepting the ultimate need for establishing full provisions, but appeared to be hoping that HMT (*sic*) would look kindly on the idea of phasing-in, which he suggested had received a favourable mention at the earlier meeting."

No further progress had been made on the reinsurance treaty, but the scrutinising actuary recorded that Headdon "expressed satisfaction that no major problems seemed to arise".

106. On the same day Hewitson recorded his rather different reaction to the paper supplied. In a memo to Allen he said:

> "At yesterday's meeting with Chris Headdon (and Tim Roff), we were left with a copy of their relevant Board papers relating to the proposed declaration of bonus by Equitable. These show that they are sensibly seeking to balance out the considerations of reducing progressively the amount of additional guaranteed benefits that are added each year, with maintaining a reasonably competitive position, and smoothing the bonus declarations from year to year in line with the perceived expectations of policyholders.
>
> The cost of the declared bonus for 1998 would be some £365 Million (compared with £508M in 1997). This would leave the overall financial position of the company as shown in their draft 1998 returns as showing cover of 250% for the solvency margin (ie similar to 31/12/97) assuming that the reinsurance with ERC is completed (and accepted by FSA as allowing a significant reduction in the reserves for GAR's), or 110% if the ERC reinsurance is not taken into account. In the latter situation, they would though be able to take credit for a larger future profits implicit item which could boost the apparent solvency margin cover to around 200%, though the explicit cover for the guarantee fund would be very thin.
>
> Therefore, the financial position shown in their 1998 returns is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under Section 33 if their proposed reinsurance is not completed satisfactorily. Accordingly, I believe that it would be difficult to object formally to their proposed course of action, though we would need to continue to monitor their position carefully.
>
> Indeed, we are very conscious of their financial sensitivity to changing investment conditions.
>
> This was demonstrated, for example, by their February 1998 paper which showed projections to the end of that year on 3 different investment scenarios. This suggested that they needed to achieve an investment return of some 16% in order to maintain their then level of solvency cover. If instead, the actual return was close to 0%, then the margin of solvency could have become uncovered. The actual variation in this ratio during 1998 is also shown graphically in their papers and came quite close to 100% last autumn (even with minimal allowance at that time for guaranteed annuities).
>
> We understand that they do not have much scope to reduce the margins in their valuation basis in those conditions, and they would very likely either have to seek some additional concessions from FSA in their reserving requirements, find some further financial reinsurance or switch their investments from equities to fixed interest. The scope for the two latter options may though be quite limited in practice due to market limitations.
>
> The figures that they have presented to us also allow us to compare the 'policy values' attributed to all their with-profit policies as compared to the mathematical reserves.
>
> These unsmoothed policy values exceed these mathematical reserves (with no allowance for the effect of financial reinsurance) by some £2.2 Million before the inclusion of a resilience, reserve or £0.7 Million after including a resilience reserve. These figures increase to £3 Million and £2.1 Million respectively if the proposed financial reinsurance is taken into account. [The corresponding figures just for those policies with GAR's would be around £0.2 Million before

resilience and £0.3 Million after resilience (with no financial reinsurance) and £1 Million if financial reinsurance is taken into account]

These figures suggest to me that our current reserving standard is not unreasonably harsh, with the possible exception of the resilience reserve requirement on the policies with GAR's which will though be dealt with by the proposed financial reinsurance. This suggests that we would not have very much scope for offering a credible reduction in our reserving standard to Equitable if 1999 should be a year with low or slightly negative investment returns. Their liability profile also shows that they will continue to have a significant number of policies in-force with GAR's (and guaranteed future bonuses of 3.5% pa) for another 15-20 years. There are also a fairly substantial level of guarantees on most of their other policies.

Meanwhile, they continue to issue annual notices to policyholders showing a high level of projected benefits and thereby generating further expectations.

Therefore, in writing to them to say that we have no objection to their current proposed rate of declared bonus, I believe that we should voice our concerns about their apparent vulnerability to changing investment conditions. We should certainly ask them to repeat for 1999 (and provide us with a copy of) the type of 12-month projection shown in their February 1998 paper, and ideally extend this to a period of 3-5 years on plausible investment scenarios.

They should also be asked to produce some contingency plans for how they would react if an adverse investment return were to appear over the next 1-2 year period, which reduced their solvency margin cover to close to or even below 100% of the required minimum level."

107. The advice left regulators in very much the position they had found themselves in recent years: Equitable was to be left to carry on as it proposed. The level of reserving for guarantees was not pressed as an issue because of the possibility that there would be an acceptable reinsurance arrangement. By this stage it would not have been unreasonable to have expected a more incisive approach. Allen called Headdon that evening. The only note of this call that has been located was made by Headdon. It recorded that Allen's view was that successful finalisation of the reassurance arrangement was critical to a satisfactory solvency position, and that the figures provided on the basis of full reserves indicated that it would be unwise to declare a bonus. Headdon responded by saying that the figures were not final and had been included to show that the office was still solvent on an extreme reserving basis. Allen said that the possible outcomes of the court case should be considered, and asked if the Society had tried to estimate the cost of compensation of it were lost. He was told that had not been done. He said that FSA felt "there was an ongoing viability issue" and would want to continue to see internal papers. But at the end of the day the decision on bonuses was for the directors, and if the Society was satisfied that it had borne in mind the factors mentioned, FSA was "not minded to intervene". The note recorded that FSA were going to confirm their views in writing.

108. Allen wrote to Nash on 1 February 1999. The letter stated that the FSA attached importance to resolving the outstanding points on the reinsurance as a robust treaty would be required for the Society to declare a bonus. Allen asked to be kept informed of progress. However, he stressed that even with the reinsurance in place the company should:

"... consider carefully the scope for declaring a bonus because of the uncertainties surrounding the financial implications of the court case... In particular it would appear necessary for Equitable Life to consider the prudence of declaring a bonus in light of the risk of losing the court case and the potential costs that might be incurred as a result. We also consider it necessary for the company to take account of the risk... of the treaty being cancelled by the reinsurer (whether as a result of Equitable losing the court

> case and having to change its payment policy, or for some other reason) because of the heavy dependence of the company on the reinsurance treaty in order to be able to show more than marginal solvency cover."

The letter confirmed the message from the phone call by saying that despite all of the above, FSA was not minded to interfere, albeit that this should not be taken as an endorsement of what was proposed. He continued:

> "Nor is it an end of the matter; we remain concerned about the on-going financial health of Equitable Life, because of the relatively low level of explicit free assets and the apparent sensitivity... to future rates of investment return."

In this context Allen suggested an early meeting and requested some further information about solvency projections and contingency plans.

109. No issue had been taken, either in the phone call or in this letter, with Headdon's 65-80% take up figures. The letter merely concluded:

> "On a related issue, we look forward to receiving in due course your response to Martin Roberts' letter of 13 January about the treatment of guaranteed annuities in 1998 returns."

110. Again there appears to have been a lack of enthusiasm for positive intervention, and preference for advice and warning of the possibility of action failing remedial steps by the Society. The briefing note for the 15 December 1998 meeting had painted a picture of a company that could not afford to declare a bonus, and it had been concluded at the meeting itself that there was power under the sound and prudent management umbrella to prevent such a declaration. However, Roberts and Allen have explained to the inquiry that FSA's approach to the bonus declaration issue reflected the proper and preferred course for the regulator, which is to encourage directors properly to discharge their responsibilities, with intervention as a last resort. Roberts disputes that he was not prepared to recommend intervention, even though he was conscious of the likely damage to the Society and that any intervention would be subject to legal challenge. And GAD had argued after that meeting that passing a bonus was "probably necessary for the prudent management of the Society". In any case, FSA did not insist.

111. On 28 January 1999 there was a meeting attended by Hewitson and Headdon among others. The draft reassurance treaty was discussed. Next day Hewitson wrote to Allen revising his advice on the declaration. He continued to have reservations, but apparently considered that they could not be pressed. In the course of his observations in maxwellisation, he has stated that, having regard among other things to internal legal advice, that was his view: regulators had no effective sanction that could be deployed against the Society. Headdon's self-indulgent interpretation of "a few % points" was disregarded by all but the more junior of the actuaries involved. GAD considered that no effective action could be taken.

112. Nash replied to Allen's letter on 3 February and promised that the further information and the reply to Roberts' letter were in hand. He also mentioned that thought had been given to the position "in the unlikely event" that the court case went against the Society, and that this was to be discussed with the Board.

113. The substantive reply to Roberts' letter of 13 January was sent by Nash on 12 February. He acknowledged that including reserves at a level "consistent" with the recent guidance in 1997 returns would have decreased RMM cover from 2.5x to 2x. However, Nash refused to commit himself on whether or not this amounted to a material effect in terms of Roberts' letter. He argued that, in light of the reinsurance agreement and the full use of a £850m future profits implicit item, there was no necessity in any event for the Society to submit the returns early.

114. Nash also wrote to Allen on the same day enclosing the updated terms of the reinsurance treaty. On the basis that the Society had strengthened the treaty terms to address the concerns raised, and had also considered and satisfied itself on the matters raised in Allen's 1 February letter, Nash concluded that there was now no

impediment to the proposed bonus declaration. Allen replied on 16 February and raised one further point of concern about the treaty relating to the settlement of claims, which he wished to see resolved before the declaration, if necessary by way of a further meeting. Headdon attempted to resolve this issue by a revised definition within the treaty, which he faxed to Allen on 18 January.

115. Despite Headdon's efforts, a meeting with GAD was still thought necessary and this took place the next day. On 22 February Hewitson wrote to Headdon outlining the discussion at the meeting on some of the details of the treaty, but he confirmed the acceptance of the principle that the agreement would allow an offset in the liability valuation as at 1998 year-end. Allen wrapped matters up with a letter on the same day to Nash which stated:

> "... subject to the reinsurance treaty having the effect of allowing an appropriate reinsurance offset to be made (i.e. an offset broadly corresponding to the difference between the gross reserves established and the value of the benefits assuming 25% of policyholders exercise the guaranteed annuity option), we are not minded to object to Equitable Life's proposed bonus declaration."

He indicated that he would write soon about the Society's stance against early submission of the returns. It was clear by this stage that the bonus declaration was fundamentally dependent on the reinsurance treaty. Objectively that depended on acceptance by FSA that the treaty involved a sufficient transfer of risk to warrant the view that the Society's annuity guarantee liabilities could be valued at a proportion only of the total risk. A redrafted agreement was sent to GAD on 25 February, but there continued to be concerns about the provisions dealing with settlement of claims.

116. At around this time it appears that FSA had started to give some thought to the court case. Handwritten notes by one of the line supervisors indicate that a discussion took place within FSA on 16 February 1999 at which questions were asked about the likely length of the hearing, whether someone from FSA should attend, and what would happen if the Society lost. Court papers were mentioned, as was a meeting with the Society.

117. On 24 February Allen wrote to Nash about early returns. It appears that the matter had been discussed by telephone after Nash's 12 February letter. Allen refused to back down and asked for an indication of Equitable's agreement to submit its returns early, or a refusal, by 3 March. If there were no agreement, appropriate regulatory action would be considered. On 26 February the Society agreed to submit its returns early.

118. The question of publication of the names of companies which had been asked to submit early was obviously taxing both the Society and FSA. On 25 February Ford advised that under the 1982 Act and relevant directive the names of those companies which had been asked to file their returns early ought not to be made public or disclosed. On 2 March 1999 Allen briefed Davies on the issue. He recommended there should be no such disclosure on the grounds that this would be "commercially damaging to the companies, and hence against the interests of the policyholders" and because of the confidentiality requirements under the legislation. On 12 March Allen telephoned Nash to tell him (according to Nash's own note) that FSA would not be issuing any press release or making any announcement about the early returns and would, only if asked, respond by saying simply that a number of companies had agreed to submit their returns early.

119. A paper providing a summary of the positions of all companies "at risk" from the annuity guarantee issue was circulated within FSA and to Chamberlain at GAD on 19 March 1999. Thirteen companies were listed in the order of the level of concern to which they gave rise, with the most serious first. The Society appeared first on the list and the summary reported:

> "The company's financial position has been very severely affected... The latest information is that a reserve of the order of £2.9bn will be required at the end of 1998. The company would only just be able to cover its solvency margin... after establishing this level of reserve and making allowance for significantly reduced levels of bonus."

The effect of the reinsurance was mentioned and the summary continued:

> "We remain concerned about the financial viability of the company in the longer term... The company has now agreed to submit its 1998 annual returns by the end of March and to provide us with financial projections for the company's business over the next 3 years. This information should enable us to make a more accurate assessment of the longer-term position The company has adopted [a differential terminal bonus policy]... The acceptability of this approach is the subject of a test case in the courts; if the company were to lose the case it could incur significant compensation costs."

120. On 23 March Allen asked the line supervisors whether two of the other companies had been written to about their differential terminal bonus policies (the Society already having been written to, and the decision on PRE having been deferred until the conclusion of the court case). Chamberlain interjected the next day to ask whether Allen was raising a general query about the ability to reduce terminal bonuses. He went on to warn of the dangers of writing only to certain companies on the topic, and advised that if the matter was to be taken further it ought to be by way of an updated general survey of all companies.

121. The senior line supervisor responded promptly to this suggestion. She explained the thinking behind seeking further information from specific companies:

> "Due to concerns over resource implications we have favoured a line of seeking information about differential terminal bonus practices and their compatibility with PRE only where it was brought to our attention that such a practice was being adopted (either though complaints, press articles, regulatory info we happen to have already) ie we weren't going to go looking for trouble but thought we needed to do something where the issue was raised. That said I take your point that there is a case for a more systematic approach."

She asked Chamberlain if he knew how many companies operated a differential terminal bonus policy and continued:

> "We certainly don't have the resources to look at large numbers of policy documents from different companies to assess whether PRE is being met. We might be able to cope with a more limited exercise that just asked companies to justify how their approach was consistent with PRE and we assessed the reasonableness of their answers. Are you saying you think we should undertake such an exercise?"

Historically, regulators had not seen it as their role to make an active assessment of PRE. This exchange demonstrated that even at this stage, when there had arisen a practice that directly and significantly impacted upon PRE, their approach remained reactive and particular. As anticipated in 1972, the obstacle to a more comprehensive approach was the resource required.[20]

The Faculty and Institute Position Statement

122. In March 1999 the Life Board of the Faculty and Institute of Actuaries had issued a document entitled 'Annuity Guarantees, Actuarial Profession – Position Statement'. It was stressed that the paper did not constitute formal guidance, but should be of use in answering questions from the public and press. Some general information about the issue was provided, and the Life Board stated that the profession supported the regulator's position as set out in 18 December 1998 and

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[20] See chapter 13, paragraphs 25 to 28.

13 January 1999 guidance letters. It had been suggested in the press that some companies had failed to reserve fully for the guarantees, but the document stated:

> "The profession is unaware of any specific examples of this but would clearly be concerned to ensure that such cases were as a result of reasonable professional differences of opinion. If not, they would be subject to the profession's disciplinary procedures. The profession will continue to pursue this question until these doubts have been resolved.
>
> The additional reserves set up to meet the guarantees are not a measure of the cost. Unless interest rates fall significantly from current levels, these additional reserves may be released in future."

Where an insurer had no constraints caused by the policy conditions, marketing literature or other documents, the terminal bonus could be set for individual policies so that the accumulated fund equalled the cost of the annuity provided.

> "The 'guarantee' may seem to be lost, but the position is no different from the position of the past under older policies with a guaranteed conversion the other way – from pensions into cash. The guarantee will still bite if terminal bonus rates fall to zero."

On the general question of who should bear the cost of the guarantees, the position statement identified four approaches, all of which might be appropriate and all of which were capable of meeting the requirements of the regulator in appropriate circumstances:

a. Cost met by the specific class of policy itself in whole or in part;

b. Cost met by other policyholders' bonuses;

c. Cost met out of shareholders' funds;

d. Cost met out of the estate.

On the likely impact of the guarantees, the statement concluded that:

> "There has been a widespread misunderstanding of the effect of these guarantees on the insurance industry. The financial effect is likely to be comparatively modest for some companies but will be significant for others."

Typically, the statement offered little practical guidance and neither a statement of principle nor a statement of the limits of professional practice, leaving decisions to individual actuaries unless they strayed beyond some unspecified line of acceptable judgment.

123. However, the position statement reflected, in the first place, the understanding shared by the professional bodies of the general guidance that had been issued: it was not seen as neutral, but positively supportive of approaches such as had been adopted by the Society. In that respect, it sent a clear message of support for the interpretation of HMT's guidance of 18 December 1998 and the Government Actuary's letter of 13 January 1999 that favoured Equitable, interpretations that, in the light of statements to the inquiry, FSA might have been expected to reject. No evidence of an adverse reaction has been found. In the second place, the statement reflected the profession's general view of the sanctity of individual actuarial judgement. 'Reasonable professional differences of opinion' allowed a wide and undefined latitude. Ranson's caustic attitude to 'interference' with his judgment by GAD actuaries has already been illustrated. The reassurance offered, that there were generally available means of resolving the issues, reflected an insular and narrowly actuarial view that failed fully to take account of wider opinion.

The 1998 Scrutiny

124. The Society submitted its 1998 returns on 30 March 1999. On the same day an application was made for a future profits implicit item of £1 billion. (Headdon's

side letter to the reinsurance agreement, which was not disclosed to the regulators, was dated two days later, 1 April 1999.[21])

125. The Society had experienced a moderate year on the market with an overall investment return of 13.3% (including an income yield of 4½%). The Society had announced a total growth rate of 10% (a decrease from 13% declared in 1997) which comprised of the 3½% GIR (0% for new policies), 1½% reversionary bonus and 5% terminal bonus). This placed the balance as between reversionary and terminal bonus at 23/77, a further shift in bonus mix towards final bonus. Part of the cost of the bonuses was met by a call on capital appreciation of £820m. The residual unallocated return again reduced the excess of aggregate with-profits policy values over assets to 105% (107% in 1997). The accrued final bonus figure now stood at £4.6 billion. The interest rate used in the liability valuation was reduced to 3¾% (4% in 1997) as against a gross bonus rate assumed of 2%. The regulatory cover factor was broadly steady at 2.5x and included credit for an implicit item of £850m and for the subordinated loan of £350m. Without these the cover would have been 1.3x. In addition more than £800m in reinsurance of annuity guarantee contracts was permitted to be set off against the total liability for these in the returns. Without any of these three concessions the cover would have been reduced to 0.5x.

126. The return included a gross annuity guarantee provision of £1.6 billion, though the reinsurance treaty resulted in the provision for a net GAR liability of under £800m. This contrasted with a provision of £200m within the accounts and the Society's commercial cost estimate, which remained at £50m.

127. Chamberlain, who had been the principal actuary responsible for the Society at the time of 1996 report, but as of July 1998 was no longer part of the scrutiny team, has told the inquiry that:

> "I had a view on Equitable even when I was not directly involved which I expressed to John Rathbone, including the fear that Equitable could possibly have breached RMM in Autumn 1998. Part of the evidence for this fear was based on the 'Mark 1' reinsurance contract which was designed to allow them to take credit for take-up rates well below 100%, but which did not look fully effective and which was not yet in place. The dramatic shift in stock market values in 1998 (a local low of 4,600, gilt rates to 4.5%) was a nasty shock to Equitable who had guaranteed roll-ups as well as GAOs. Based on my informal discussions with other companies, I had concerns about Equitable's position. However, Headdon was certainly saying that Equitable was solvent and GAD/HMT had no actual evidence to dispute this view."

128. No doubt due to the explosion of the annuity guarantee issue there had been no scrutiny report on the 1997 returns, and therefore the regulators had not had the benefit of such a report since the 1996 scrutiny report in December 1997. GAD completed the initial scrutiny of the 1998 return on 9 April 1999. The report made the following points:

i. The financial position shown on form 9 appeared satisfactory with a cover factor of 2.5x (the cover without the implicit item would be 1.66x);

ii. The gross reserves for the guarantees (£1.6 billion) were lower than hoped for as Headdon appeared to have made allowance for non take-up of the GARs "to a greater extent than we thought he should". It was noted however that the assumptions made were more prudent than had been suggested in the January Board paper.

iii. Even if the take up rate was increased, the solvency implications for Equitable would be negligible because of the reinsurance treaty. It was stated:

[21] See chapter 7.

"We can only presume that the company was reluctant to disclose any higher figures for its gross liability, or for the extent of its consequent reliance on reinsurance."

iv. An application had been made for an increased future profits implicit item of £1 billion for 1999.

GAD predicted that the full scrutiny would be completed in June. Despite providing the cover factor without the benefit of the implicit future profits item, the report did not provide an equivalent calculation which showed the precise extent of the support to the solvency margin cover being provided by the subordinated debt and reinsurance.

129. GAD's reaction to the Society's reliance on low rates of take-up in effect acknowledged that the valuation was not in accordance with the guidance, but the report noted only that the situation could have been worse. The scrutinising actuary who wrote the report was the only person who seemed to have reacted at the time to the figures in the January board paper (he had made the phone call on 29 January to Headdon). His rejoinder to Headdon that "...these adjustments would require further discussion before he could expect the supervisor to accept them as producing acceptable prudent reserves"[22] seems to have been taken no further. It is not clear whether the issue was considered and resolved by a decision that the Society's position was acceptable, or not considered at all. If GAD or FSA had considered that Headdon's take-up rates could not be justified, one might reasonably have expected discussions before the Society submitted its return. It is difficult to identify good reason for inaction, possibly in the hope that the Society would have changed its mind by the time of the return. The scrutinising actuary's comment in January that Headdon "seemed to be gradually accepting the ultimate need for establishing full provisions" had proved over-optimistic.

130. Not only had the Society not accepted the FSA's position on reserving, it was now actively campaigning against it. The president, John Sclater, raised the issue with the Economic Secretary to the Treasury at a dinner on 21 April, and she invited him to put his concerns to her in writing. He did so on 30 April 1999 and enclosed a note on the topic of the same date prepared by Headdon. Sclater described the Society as operating on a "true mutual basis" (mutuality, he pointed out, being a principle supported by the Government) and complained of the "extremely onerous" reserving requirement, which he said bore little resemblance to commercial reality. As evidence of this he cited the auditors' sign off on the statutory accounts which included the much lower figure of £200m. Sclater argued that the ultimate effect would be to disadvantage policyholders, and therefore the State (in the form of greater demand for pension provision from public funds).

131. The attached note by Headdon repeated the £50m cost estimate (and said that current experience was more favourable than that figure implied) and the arguments in favour of the Society's approach, one of which was as follows:

"The Society has been able to establish a reassurance arrangement which mitigates around 50% of the additional reserves of £1.6bn mentioned above. The fact that quite a modest reassurance premium can result in a £0.8bn offset in statutory reserves would again seem to point to the excessively prudent nature of the statutory requirements."

Referring to Headdon's note, Sclater pitched his request for ministerial assistance in the following terms:

"The points in Christopher Headdon's note have all been debated at some length with FSA/GAD. While FSA/GAD clearly understand our views and have sought to be as helpful and constructive as they can... it does seem that FSA/GAD currently have relatively little room for manoeuvre. It may thus need

[22] See paragraph 105 above.

an intervention at Ministerial level to secure a more commercial and satisfactory outcome."

132. The matter was passed to FSA (and GAD) by the Treasury, who also provided them, for their comments, with a copy of their proposed draft reply for the Minister to send to Sclater. There was extensive discussion involving GAD, FSA and HMT. On advice, the Economic Secretary responded to Sclater on 14 June with a polite refusal to interfere.

133. In the meantime FSA still lacked the further information about solvency projections and contingency plans requested by Allen on 1 February. They chased the Society for these (and a copy of the finalised reinsurance treaty) on 15 April. On 20 April Nash supplied further information about the term sheet on which the reinsurance treaty was to be based (the final treaty was still awaited from the reinsurer), and some board papers about protecting the solvency position. He promised that the solvency projections would be forthcoming soon.

134. The paper on the solvency position was by Headdon and dated 18 March. It identified possible fallback measures to cope with future adverse scenarios. These included technical measures, in particular raising further subordinated loan capital; taking account of greater future profits (although this would be limited given the reinsurance treaty); further financial reinsurance, although the type contemplated might be seen by some as "the last desperate action of an office running into solvency problems"; the use of options or an increased fixed interest proportion of the investment mix to protect the GAR exposure; increasing the income yield on the assets by switching from equities to fixed interest and rebalancing the equity portfolio to higher yielding stocks; and the enforcement of policy conditions to restrict growth in guarantees, by limiting premium guarantees to cases in which there had been strict compliance with contractual stipulations. There was little enthusiasm for the last measure.

135. The paper also covered product design and means of controlling new business mix. In relation to the former, it was indicated that the Society might market contracts with no declared bonus additions at all, with all returns paid by way of final bonus. It was stated that this approach had been used in the managed pension product for the last twelve months and that there had been little policyholder complaint (although the paper acknowledged that this might have been for other reasons). The control of new business mix by increasing emphasis on unit-linked products had also been discussed internally.

136. In its conclusion the paper recommended taking on more subordinated debt, further use of reinsurance, higher yielding equity, limiting the extent of exposure to development property situations, plus:

- investigating the merits of introducing a new bonus class for GAR business;
- actively encouraging people to give up their annuity guarantees; and
- gradually introducing new products with no entitlement to declared bonuses.

The inquiry has seen a chronology for 1999, which appears to have been prepared by the FSA as part of the Baird review, and which suggests that this paper was the first communication by the Society to regulators that set out an explicit recognition of the problems associated with the fact that policyholders had premium guarantees in their GAR contracts in addition to the annuity guarantees that had been discussed previously.

137. GAD commented on Nash's letter, the reinsurance term sheet and the board paper on 27 April in a letter to FSA. GAD were now content with the level of subordination proposed in the term sheet. Commenting on the paper, they described the idea of new products with no entitlement to declared bonuses as "imaginative", but were more cautious about the plans to use strict policy conditions to restrict the

impact of the annuity guarantees. The inherent risks associated with products wholly dependent on final bonus were not rehearsed. The Society had sold with-profits bonds with limited or no right to declared bonuses for several years.

138. The promised solvency projections were sent on the 4 May 1999 and consisted of a paper prepared for the Board by Headdon dated 23 April. This projected solvency cover for the 1999 year-end of 1.3x, 2.6x and 1.7x based on three scenarios (low, central and high). This pattern was explained as resulting from the additional GAR reserves. The estimate of the commercial cost of the annuity guarantees remained at £50m, although the paper noted that actual experience was more favourable. Efforts had been made to project the impact of losing the court case, but this had proved difficult. On one outcome ("not the worst possible") there would be a reduction in cover on the central scenario above of 2.6x to 2.1x. However on the low scenario above, "the position would become unacceptably tight", on the same hypothesis. The situation was summarised as follows:

> "(i) The solvency position was somewhat less sensitive to changing conditions than in the past and the Society was solvent on a range of different scenarios;
>
> (ii) The longer-term projections were for an improving technical solvency position reflecting the benefit of various factors;
>
> (iii) The shorter-term position could be strengthened by a number of the measures discussed in March and were being actively pursued; and
>
> (iv) The impact of an unfavourable outcome to the court case was difficult to model but the key solvency consideration was replacement or modification of the reinsurance agreement, which was also being actively pursued."

Scrutiny Report for 1998

139. The full scrutiny report, dated 20 May, ran to some 23 pages and headlined the Society's priority rating as 2. It combined comment on both 1997 and 1998. The key features section tabulated financial statistics for the two years, reflected in cover for RMM of 2.51x for 1997 and 2.50x for 1998. Action points covered the need to consider the final terms of the reinsurance treaty; and the need for a policy decision whether to challenge some of the assumptions made by the Society's actuary in setting the level of provisions for the annuity guarantees. The executive summary was in part repetitive, commenting on full distribution and the low free asset margin, for example, and in part rather anodyne, mentioning that the solvency position was complicated. Background features were again repetitive. But it was observed that the Society had initiated the test case to "try and obtain legal clearance" for its differential final bonus practice.

140. Tables were included of new business, detailing new products that had been introduced between 1997 and 1998; analysing total regular premium new business income and total of single premium new business income for 1994-1998. There was a year on year increase of 19% in regular premium income in 1997 and a decrease of 15% in 1998. Single premium income for 1997 showed a year on year increase of 23%, and for 1998 an increase of 12%. It was noted that it appeared that in 1998 the Society had under-performed the industry average regarding increase in new business but it was suggested that this could be put down to the Society's starting position, and the excellent new growth figures from 1997, when the Society was reported as the largest writer of pensions business in the UK. It was reported that there had been a 15% increase in expenses in 1997 and 7% increase in 1998. But reported expense ratios remained the lowest in the industry, having reached "astonishingly low levels" in the standard formula.

141. In relation to valuation and solvency, the scrutiny report commented on the valuation basis, and stated that the net premium basis used was acceptable, subject to an issue about the annuity guarantees. It commented that:

> "The Society informed its holders of accumulating with profits contracts of the amount of their accumulating final bonus (although clearly stating that it was

not guaranteed), but only held reserves for a discounted sum compared with the current guaranteed value.

Total current "asset shares" (indicated to members as their policy value) exceeded total current admissible assets" and

The solvency position was complicated by the GAR reserving issue, about which there had been extensive discussions between GAD and Headdon and in respect of which there had been an attempt to mitigate the strain by way of a reinsurance contract."

142. The report commented that there had been adverse press publicity relating to the application of the differential final bonus practice and that there was to be a test case in July 1999. Loss of the case would result in a need for the Society to reduce its terminal bonus additions for a wider group of policyholders – "maybe all!". It stated that the appointed actuary had set up annuity guarantee reserves of £1.6 billion with £800m of this being ceded to an overseas reinsurer. It commented that:

> "In deriving the level of the required reserves, the Actuary has made assumptions about the maximum percentage of maturity benefits that would be taken in guaranteed annuity form, and in doing so has somewhat stretched the concessions offered by the [Government Actuary] in his guidance letter..."

The rates were set out, and it was stated that:

> "It is necessary to consider whether the Actuary's reserving assumptions for annuity guarantees should be challenged."

The returns were said to have indicated that allowances had been made for perceived advantages of alternative forms of benefit, the bonus system, the availability of cash commutation options and for certain advantages available to higher rate tax payers in commuting for cash. There had then been discounting for mortality in deferment. However, the proportions of benefits assumed to be taken in non-guaranteed annuity form might still be thought to stretch the guidance given.

143. In relation to the Society's financial results, the scrutiny report commented on the cover factor for RMM, and the implications of reserving fully for annuity guarantees. It proceeded:

> "A large proportion of business is written on a participating basis, so that, provided the currently high level of annual emerging surplus continues, the Society should be able to work its way out of its current solvency margin problems. However, it does seem highly desirable for the Society to mitigate the risks posed by the possible down turn in asset values, by holding back more emerging surplus by declaring lower guaranteed bonuses – although it can still pay out appropriate final benefits to its members with declarations of 'non-guaranteed final bonuses'.
>
> To be fair, the Society appears to be proceedings down this path – although mindful of the need to sustain a competitive position in the market place."

At the end of May 1999, therefore, GAD continued to focus discussion on regulatory solvency, acknowledging the practice of topping up total returns by increasing final bonus, and encouraging the approach of reducing declared bonuses. There was no recognition of the incidence of the cost of this approach on in-force business generally or on new business in particular. Dependence on sustained high levels of annual surplus was identified. It was implicit in the comments that returns on new premium income would be restricted by the need to recover from current solvency margin problems, but the implications of that were not developed.

144. In relation to the bonus structure, the scrutiny report commented that the method of annual bonuses for unitised type contracts was unusual. Final bonus, although not guaranteed, was shown as part of the accrued policy value. It was noted that the final bonus was 'declared' as a percentage of benefit and that the amount of final bonus payable at maturity was the sum of these annual declarations

(subject to the proviso that the non-guaranteed final bonus could be withdrawn). The change of language in the report reflected changes in bonus publications. It appears to have been accepted without challenge that established policyholders' reasonable expectations, based on earlier formulations, could be altered unilaterally by the Society.

145. Comments on PRE in the report continued to reflect complacency:

> "The Society tries very hard to achieve an equitable distribution to each generation of its policyholders, whilst avoiding short term fluctuations in benefits – with the result that it has not accumulated any material unallocated estate compared with accumulated asset shares (if any...)... (W)ith such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback."

This was hardly the warning of the destructive potential of the Society's practice that one might have expected at this stage. The scrutiny report relayed nothing of the earlier, general concern about the Society's ongoing viability (for example Allen's 29 January call to Headdon and the paper prepared on 19 March). Much of what had been discussed since the summer of 1998 seemed to warrant little mention; aside from the noting of the court case, the PRE section repeated verbatim the terms of the 1996 scrutiny report.

146. The relative complacency of the report reflects the extent of the reliance being placed upon the reinsurance treaty by both GAD and FSA, and the concentration of attention on regulatory solvency rather than any realistic view of the Society's long-term position. The scrutiny report did not make explicit the level of the RMM cover without the combined effect of the implicit items, subordinated debt and reinsurance. On the major issue which on any view remained active and unresolved between the Society and the regulators, i.e. the extent of the GAR reserves, the report lacked the bite one might have expected given the Society's repudiation of regulatory guidance, in describing the figures as "somewhat stretch[ing]" the guidance. The difference between the January Board paper figures and those in the returns, from which GAD seemed to take some comfort, was as follows:

Type	January Board Paper	Regulatory Return
UK retirement annuities	65%	70%
UK individual pensions	75%	82½%
UK transfer plans	-	82½%
UK group pensions	80%	82½%

The scrutinising actuary had expressed concern about figures in the board paper at the time, and had suggested that they would have to be discussed with GAD or FSA, something that had clearly not happened. The return figures were a marginal improvement, but they still represented an interpretation of "a few % points" as being between 17½% and 30%. It is difficult to see, on any common sense view and even on Chamberlain's understanding (i.e. under 10%[23]), how these new figures could have been seen other than as a clear breach of the guidance. The Government Actuary's letter had made clear that any figures in excess of a few % points would "require very careful justification by the actuary".

147. The senior line supervisor initially took a more robust view. On 24 May she sent an extract from the return to Allen, setting out the figures, with the following note:

[23] See paragraph 95 above.

> "This is an extract from the GAD scrutiny of Equitable Life's annual returns. I think we will have to challenge the GAO reserving assumptions. Making allowance for cash commutations is contrary to specific guidance given by the GA and a reserving level of 70% seems unacceptably low. Please can we discuss handling."

The extract was annotated to show that the 70% figure related to Equitable's largest block of business. A conversation must have taken place that day or the next (although no record has been located) because on 25 May the senior line supervisor e-mailed GAD to say:

> "I have discussed with Roger Allen how we approach Equitable's low gross reserve for GAOs and we have agreed that a low profile approach to obtaining clarification of the basis for their level of reserving is the best way forward. Therefore we agree that GAD should write to the company seeking clarification of the GAO reserving (including the determination of the reinsurance offset) and present this simply as a normal request for clarification of actuarial assumptions.
>
> Please can you let me see a copy of your draft letter to Chris Headdon."

148. The draft letter was approved on 27 May and, as requested, it simply sought clarification of the basis of the reductions and the calculation of the reinsurance offset. GAD also asked some further questions about the projections paper supplied on the 4 May 1999. The reply was dated 25 June, by which time FSA were more concerned about the court case. Headdon's response explained the basis of the reductions as follows:

i. A reduction of 5% due to the bonus system (which he related to the restriction of a few % points).

ii. In respect of the additional flexibility and other advantages of alternative forms of benefit, the following further reductions:

a.	Retirement annuities	10%
b.	Individual pensions and transfer plans	5%
c.	Group pensions	10%

iii. A further modest allowance for the availability of cash commutation options to higher rate taxpayers as follows:

a.	Retirement annuity	15%
b.	Individual pensions and transfer plans	7.5%
c.	Group pensions	2.5%

The letter went on to set out the basis of the reinsurance offset and the details of the provided projections.

149. GAD replied to this on 15 July 1999 (by which time the court hearing had taken place) and told Headdon that formal consideration of his justifications would be deferred until after the outcome of the case was known, but that GAD still had some difficulty in accepting that 17½ -30% could be consistent with a few % points. Headdon persisted and on the 19 July replied that a few % points in the guidance letter did not relate to the combined effect of all factors, but to each individually. The subject was not to receive any further attention until 24 September, at which time GAD closed the scrutiny, without any resolution or reply, and suggested that the topic might be discussed at a meeting with the Society planned for December.

150. In the meantime, the litigation took centre stage. In the 1997 and 1998 returns Headdon had included specific resilience reserves, reflecting in the computation the quasi-zillmer adjustment for un-recovered procuration costs. That issue had not been uncovered at this stage in the scrutiny process.

CHAPTER 18: LITIGATION AND CLOSURE

The Court Case Looms

1. The High Court hearing was due to commence on 5 July 1999. On about 8 June the senior line supervisor circulated a paper entitled 'Equitable Life Court Case – Possible Scenarios'. So far as the inquiry has discovered, this was the first document prepared by GAD or FSA which recorded any substantive consideration of the court case. By this time FSA had received Nash's 4 May paper, which touched on the subject. The FSA paper noted that the Authority was to meet with the Society to discuss its contingency plans in respect of the case and set out the following three scenarios and their implications for the company and the FSA (presented here only in summary form):

i. Equitable win totally (past and current practice of reducing terminal bonus is acceptable within the terms of the contract).

The Society could continue as before, but although solvent, it would remain "relatively weak" for a with-profits office and there was potential for an appeal; and

FSA would have to continue to monitor solvency closely, and "consider whether PRE was an additional factor to be taken into account in considering intervention or whether the court ruling should be considered definitive on policyholder rights". The PIA Ombudsman would have to resolve complaints.

ii. Equitable win in part (current practice of reducing terminal bonus acceptable, but past practice unacceptable).

The Society could continue as was but would need to pay compensation (which was unlikely to be substantial relative to reserves, possibly about £400m), and might also suffer significant reputational damage;

FSA would have to continue to monitor solvency closely and consider PRE as under (i). "Expect to conclude Equitable current practice is consistent with PRE but more doubtful about whether the same could be said of past practice (because bonus notices of dubious clarity in the past)". FSA would have to review the PRE guidance and discuss the implications of the judgment with firms. The PIA Ombudsman would have to resolve complaints.

iii. Equitable lose (reducing terminal bonus where GAO existed is unacceptable).

The reinsurance would be invalidated if the Society had to change its bonus practice (which it might not have to if an appeal was pending) and could possibly be replaced. Without reinsurance the Society could only just cover its RMM, but this might improve if some of the measures considered had been put in place. The Society would have to look at a substantial reduction of terminal bonus to all policyholders (or maybe just those with annuity guarantees). This might lead to takeover bids, reduction in new business, increased lapses, and early retirements. The Society would have to think about switching into gilts to protect solvency and would need to pay compensation. Its credit rating might be reduced further.

FSA would need to determine the Society's solvency. If in breach, a 'section 32 notice' would have to be issued requesting a scheme to restore a sound financial position. Even if the Society was not in breach, financial projections would have to be obtained and monthly monitoring. FSA would have to consider closing the company to new business if there was a significant risk that the company would be unable to meet

liabilities and PRE. The Society might have to be encouraged by FSA to reduce surrender values and be alert to a wider loss of confidence in the industry. Consideration would also have to be given to the possibility of takeover bids, falls in new business and any increased lapse rate.

2. GAD responded to the paper on the 9 June, commenting that Nash's paper would also have to be considered, and reminding FSA that the issue of the annuity guarantee reserves was still unresolved. GAD also stressed that if the case were lost by the Society, the renegotiation of the reassurance treaty would be "essential to sustain an acceptable disclosed solvency position".

3. On 11 June the senior line supervisor phoned the Society to arrange the meeting. Nash's note of the phone call recorded that:

> "She [the supervisor] makes the point that all FSA/GAD currently know about the case is what they have read in the press. They don't even know what it is the Court is being asked to decide."

FSA asked to be supplied with affidavit evidence and any contingency documents. On 14 June the senior line supervisor circulated a slightly revised version of her scenarios document to her FSA and GAD colleagues and noted that the Society had been asked for the court papers.

4. On 14 June FSA (including the conduct of business regulators) and GAD met the Consumers Association to discuss the annuity guarantee problem. According to the minutes, the Consumers Association were assured that companies that had given guarantees had been required to reserve for them fully. After the meeting the prudential regulators sought a view from their conduct of business colleagues on whether the PIA (formally still the conduct of business regulator under the Financial Services Act 1986 regime) had jurisdiction to look at material on pre-1988 policies. The conduct of business regulators received advice the next day from their legal advisers that they did have jurisdiction, although it appears that by 24 June this conclusion still had not been passed on to the prudential side.

5. On 21 June 1999 Nash wrote to FSA with a document dated 17 June, prepared by one of the Society's senior actuaries, which considered various scenarios in relation to the court case outcome. Allen had requested such a document or its equivalent in his 1 February 1999 letter. Nash's letter explained that their lawyers had advised against the creation of a fully documented contingency plan to avoid discovery in the litigation process. He assured Allen, however, that considerable thought had been given to the possible outcome and that discussions were ongoing with the reinsurer about amendments in light of the worst outcomes.

6. The paper outlined six scenarios (Nash commented in his letter that scenarios 5 and 6 were "thought highly unlikely by our lawyers"):[1]

i. Complete success.

ii. Success but with some adverse comment in the judgement.

iii. Directors had a discretion but had incorrectly executed it on technical grounds.

iv. Directors had discretion but had not given sufficient weight to or considered the right PRE.

v. Ruling that Equitable approach was invalid and that final bonus rates on cash and annuity benefits must be equal but that the Board still had discretion to set rates at a level they deem appropriate.

[1] See also chapter 1, paragraph 95.

vi. Ruling that Equitable's approach was invalid and that the final bonus rates on cash and annuity benefits must be equal but due to PRE must be at cash levels.

Under the final scenario, the following actions and consequences were listed:

- Retirements on day and ongoing likely to be very high;
- Any Board resolution would probably be backdated to the date of judgment and so retirements might be suspended between the judgment and the Board resolution;
- Board resolution could be prepared in advance;
- Systems would cope with the new ongoing rates for some GAR policy types but not all, and so manual calculations would be required for several months;
- Surrenders likely to be large;
- Past retirements would almost certainly require further payment.

This formulation of the consequences of the worst-case scenario was focused on immediate or short-term administrative problems. It did not identify any longer term considerations relating to the Society's future.

7. The meeting with the Society about the case was scheduled for 29 June. The court papers requested were provided, and an internal FSA document set out the issues the Court was being asked to decide and the positions taken by the various parties. The paper commented that the Society had indicated that, in the event of losing the case, it would look at spreading the annuity guarantee cost across the policyholders who had such an option (irrespective of whether they had exercised it) rather than across all policyholders. The 'ring-fencing' solution in the event of failure was therefore identified for regulators at this stage. On 22 June GAD prepared a further note on the papers, which analysed in particular the main affidavits in the case.

8. On 24 June Hewitson e-mailed FSA with his initial thoughts on what might happen if the court decided in the Society's favour on the contract issue, but referred the question of PRE back to the FSA. One possibility would be to apply a test similar to that which would be applied by the courts in a judicial review, by which he meant that the Society's stance on PRE might be tested by reference to bad faith or failure to take into account salient facts. He suggested that such an approach avoided the risk that FSA might be seen to be interfering in the commercial decisions of an insurer which properly fell to the directors. He said:

> "In my view, and taking account of both the relative ambiguity of the material presented to policyholders and also the Equitable's long-stated position on the financial management of the society (with no estate being maintained), their position that the GAR policyholders should receive benefits equivalent in value to asset share (except where the guaranteed fund applied at the GAR provides larger benefits) is tenable on both counts. While they could have reached an alternative position that gave some higher benefits to these policyholders, I would doubt that we could insist on this if we apply the above test."

9. Secondly, he commented that the unfair contract terms legislation allowed the alteration of charges for financial services without notice where there was a valid reason, provided that the policyholder was told at the earliest opportunity and allowed to dissolve the contract immediately. In that case, he said:

> "Equitable do appear to have so informed policyholders of their change of practice on the application of GARs in annual bonus notices, and each policyholder does have the right to cancel the contract and switch to another provider."

Next to the above quotation someone has added in handwriting: "no – this is very much debatable". Hewitson went on to suggest that the prominence of the notification would be a matter for the Ombudsman.

10. Thirdly, Hewitson commented that any issues concerning whether a policyholder had been misled at the point of sale ("as may be an issue with the additional contributions made by Mr Hyman") would be a matter for the PIA.

11. His fourth point was that if the FSA were to regard the illustrations and annual bonus notices as giving rise to an expectation about how the annuity guarantee would be applied, a similar question would have to be addressed about the levels of final bonus shown therein. Either:

a. the final bonus could be seen as binding in all circumstances, including a change of investment conditions, or

b. the final bonus could be variable in line with investment conditions, but not otherwise, or

c. the final bonus could be variable, subject only to smoothing over a reasonable period of time.

He considered it unlikely that a reasonable policyholder would be held to expect that "such illustrations" provided an absolute guarantee in all circumstances, and interpretation (a) would have severe consequences for the whole industry. The second interpretation was more plausible, but he believed that most policyholders would still expect to participate in all the profits or losses of the business. If the second alternative were a reflection of policyholders' expectations, it would be very difficult to reduce terminal bonus, and that could result in an increased cost of £2 billion to the Society. The Society would lose the reinsurance cover, but would just remain technically solvent.

> "In effect, they could be expected to argue (and probably state publicly) that FSA had signed their death warrant (since their position as an independent mutual would become almost untenable)."

Under the third interpretation, which he noted was the scenario Headdon had considered in the earlier board paper, the Society could survive, but would be weakened commercially and financially.

12. The note concluded by saying that overall, taking account of his first two points, it would be Hewitson's inclination not to intervene in these circumstances, but he suggested that FSA might see some attractions in the third interpretation outlined under his fourth point. Hewitson had thus made his preference for non-intervention on PRE grounds abundantly clear, albeit without reference to or analysis of the relevant documents over any substantial period of time.

13. A contemporary reaction to Hewitson's paper was set out in a comment made by the senior line supervisor in an e-mail to Ford about the document on 28 June:

> "I never came back to you on William's comments on PRE – mainly because I didn't know where to start or what to make of it! I would have expected an actuary to argue from a point of principle what constituted PRE rather than look at what might be a convenient result for FSA."

In my view the comments in Hewitson's memo were ill-constructed, and were poorly supported by analysis of relevant documents. I refer the reader to the analysis of the documentary material in the chapter on PRE and Equitable's practice.[2]

[2] In his maxwellisation representations, Hewitson has referred to this, among other comments, as 'supposedly' critical of his conduct. I have to assume that the criticism is not accepted. I have given careful thought to the implication that Hewitson remains the best judge of the material, but I have come to the conclusion that my remit required me to form and express my own views on the evidence recovered, whatever Hewitson's view of my inquiry.

14. The senior line supervisor's different view of the matter was also reflected in her earlier e-mail of 24 June to the conduct of business regulators (whom she was chasing for a decision about jurisdiction). She stated:

> "I would also like to know whether you have any jurisdiction in relation to the annual bonus notices issued to policyholders (both for pre 1988 and post 1988 policies).
>
> We have for some time been unhappy with the format of Equitable Life's bonus notices because we think that the way terminal bonus is indicated is potentially misleading."

The conduct of business regulators agreed that day to have a look at the annual bonus notices.

15. On 25 June the senior line supervisor wrote to Allen about reaching a decision on PRE as regards the annuity guarantees. This decision had been deferred by Allen in January on the basis that further work should await the outcome of the *Hyman* case. The hearing of the case was now imminent and FSA now recognised that the issue might have to be resumed. It is unclear what work had been done in relation to PRE since the deferral. The senior line supervisor was clearly mindful of the possibility that any determination could be subject to judicial review and suggested that "further" analysis of the policy documents be undertaken, although a formal decision would have to await the outcome of the case:

> "I think we will need at our meeting next week to flag to Equitable that PRE remains a live issue for us. They may otherwise conclude that silence indicates that we are content."

She also noted her request to the PIA and repeated her observation that the bonus notices:

> "... appear liable to lead policyholders to have potentially unrealistically high expectations of total payouts... The format of bonus notices is something we have raised with Equitable previously (before the GAO issue arose) but we never made any progress in obtaining changes."

16. The format of the bonus notice which was thought problematic by FSA had been introduced in 1990 for the 1989 declaration. The first real discussion about the presentation of the final bonus was in the scrutiny report by Chamberlain for the year 1993 (dated November 1994). From then on it had been noted in scrutiny reports, but no action taken, save for an expression of concern by GAD. By the May 1998 meeting between GAD and the Society concern had increased. However the fact remains that an issue that had been flagged up for a number of years had not been resolved by the regulators.

17. The first meeting with the Society about the court case took place on 29 June (a few days before the hearing was due to commence and over six months since the Society had notified HMT of their intention to raise proceedings). The FSA minutes recorded that the Society considered that scenarios 1 and 2 (from the paper sent on 21 June) were very likely, but 6 was "inconceivable". Headdon confirmed that none of the strengthening measures mentioned in the April board paper had actually been put in place, but they were retained as contingency plans. Nash believed that if the outcome was anywhere between scenarios 1 to 4 the reinsurance would remain in place, but as a contingency there had been discussion with reinsurers about increasing the scope of the cover (though the Society were awaiting the outcome of the case before talking to too many reinsurers).

18. Allen stressed that even if the Society did win the case, FSA still needed to investigate PRE, about which there was some concern although no view had been reached (to which Headdon responded that the Court might think this had already been considered by the regulators). Nash confirmed that the Society would appeal scenarios 5 and 6. He also confirmed that the Society had in one or two cases paid unadjusted terminal bonus on biting annuity guarantee policies, but this had been

by way of compensation for administrative errors. The Society had adjusted bonus notices as recommended by its legal advisers and Nash agreed to send in a copy of the latest bonus notices and other relevant documents.

19. Finally, Nash stated that the Society would continue to avoid building up an estate, which was a useful deterrent against predators. The Society had been approached by a number of suitors but they had been told that the company remained committed to mutuality.

20. The Society wrote its own minutes of the meeting, which recorded that FSA were quite clearly concerned about the court making some comment about the regulator's involvement in PRE:

> "We advanced the view that the Court could possibly feel that, since the regulator had to date taken no action regarding PRE, by implication the FSA was not concerned about the PRE position. They seemed somewhat alarmed by that and said that their formal position was that they were still considering the documents we had provided last year and had not come to any final view on the PRE issue. It was clear, however, that their considerations were not being pursued with any urgency."

These minutes also recorded that FSA had enquired about the possibility of a "link up with another organisation" in the event of a very adverse outcome, and had been reassured by news of the various approaches that had been made. FSA also requested to see the transcripts of the hearing in due course. The minutes concluded:

> "The mood of the meeting was affable and constructive. The regulators were clearly as interested in their own position as in that of the Society."

On 30 June the Society supplied the promised recent bonus statement and a copy of a recent letter sent to policyholders about the case.

21. The hearing began in the High Court as scheduled on 5 July and lasted three days. The senior line supervisor acknowledged the start of the case with a memo of the same date and attached a version of her previous three-scenario paper. The memo noted that the impact of the outcome on the Society's financial position would have to be monitored, and that unless the judgment settled matters in their entirety, FSA would have to undertake a "significant exercise" to determine whether intervention was necessary to secure PRE (in respect of which she set out a number of questions). She noted that some "initial work" had already been done in this regard but that more would be done pre-ruling (including considering whether it was necessary to seeks views from policyholders). The Society's full co-operation was also noted. The memo mentioned that the conduct of business regulators were considering the bonus notices, and her view about their potential to mislead was again repeated. A document attached to the memo about press lines for the case indicated that, if the Society lost, FSA would say that they did not think this would have a significant impact on the level of reserves the Society would need to hold to cover its liabilities. Some ten days later GAD wrote to Headdon informing him that any consideration of his reductions to the GAR take-up rates would be deferred until after the outcome of the court case.

<u>The risk assessment</u>

22. In August 1999, while the outcome of the case was awaited, FSA prepared an "initial risk assessment" of the Society as part of a pilot project for a new risk-based approached to supervision. In it the Society was classified as a "high financial risk" because of the level of guaranteed benefits, low free asset position and the difficulty of raising external finance. Under the heading 'Management' the Society's cultural attitude was described as having:

> "A tendency toward arrogant superiority regarding the efficiency of their operations and the high priority given to the interests of policyholders. This can blind them to the financial risks that can arise as a result of guaranteeing

> high benefit levels. However they are open with the regulator and there are no particular concerns about the level of co-operation that has been shown in the past."

The assessment acknowledged that there was little evidence available about corporate governance.

> "The board papers that have been seen relating to the setting of bonuses suggest that the board is presented with the necessary information in order to make a decision and Mr Nash's affidavit in the GAO court case states that there were full and active discussions of bonus policy. The company has adopted the Combined Code on Corporate Governance."

Under the heading 'Financial' the assessment included the usual comment about the Society's vulnerability to a change in economic circumstances and noted:

> "[The Society] has taken heed of our concerns about the level of reversionary bonuses and has made some effort to reduce these this year. Further reductions will be needed in future years if the risk is to be significantly reduced."

The report reflected attitudes to Equitable that had persisted over recent years.

23. By 12 August 1999 the senior line supervisor had reviewed some transcripts of the hearing. She sent a detailed summary of them to Allen and communicated her view that, while "the case could go either way", a win for the Society appeared the most likely outcome. She noted also that both sides had played down the issue of PRE. By 26 August the Society had secured an amendment of the reinsurance treaty to provide cover for 90 days after any change in GAO practice as a result of the court case.

The High Court Judgment

24. The Vice-Chancellor's judgment was issued on 9 September 1999. The Society issued a press release welcoming the decision and on 16 September wrote to all policyholders describing the decision as "totally in the Society's favour". Hewitson e-mailed FSA noting, among other things, that the decision supported both the PRE and reserving guidance, but that FSA might still need to consider some intervention on PRE grounds (although the numbers of policyholders and the amounts would be low). The next day Ford provided a summary of the judgment, which she described as a "curate's egg". Her note pointed out that:

i. The decision had determined that GAR policyholders did have a reasonable expectation that they would receive full terminal bonus with a GAR annuity;

ii. Based on the evidence seen so far, FSA would be likely to come to the same conclusion;

iii. FSA would therefore need to consider whether action should be taken under section 45 of 1982 Act to ensure sound and prudent management;

iv. However if it were concluded by FSA that the Society had not had due regard to PRE there would be a "real awkwardness" in taking action against them for "all sorts of reasons" (including the use of grounds directed at good management rather than conduct of business);

v. "There is also a PIA 'ring' to this case" (the summary had been copied to them); and

vi. "Given that the Court of Appeal may overturn the judgement or in effect alter its contents, including the findings on PRE, you have decided to defer reaching a decision on whether to take action until the appeal is concluded."

25. On 13 September the senior line supervisor suggested to Headdon that there should be a general company visit in early December (the last such visit had been in November 1996). Headdon agreed. In the meantime, notwithstanding outstanding issues, GAD took the view that, with the reinsurance that was in place, a stronger approach to reserving would raise the Society's gross liability, but not its net liability, and raise to a modest degree the Society's RMM. The topic could be discussed at the proposed FSA visit. But in the circumstances the scrutiny of the returns was considered to be closed.

26. On 24 September the scrutinising actuary advised the line supervisor on the £1 billion implicit item. The calculations were said to be in line with the guidance, about a third of the maximum allowable, and he noted that the amount requested was much lower than the sum granted for 1998. GAD had no real doubts that FSA could reasonably grant the application, although he noted that some element of the emerging surplus was presumably being used to meet the premiums for the reinsurance. He suggested that Headdon be asked to certify, in addition, that

> "... the amount applied for does not exceed the present value of future profits that may be expected to arise in the future on the long term business in force on 31 December 1998, in excess of sums that may be required to meet claims recovery premiums payable under the treaty..."

He also suggested that FSA take the opportunity to request a copy of the final, signed reinsurance treaty.

27. On 14 October 1999 the Society provided a copy of the actual reinsurance agreement (but not the 'side letter'), which had been signed by Headdon only three days before. Also enclosed was a revised application for the future profits item of £1 billion. GAD confirmed on 22 October that the reinsurance treaty was in accordance with the term sheet reviewed in April, and approved the future profits implicit item.

28. On 3 November the line supervisor provided his own analysis of the factors material to approval of the future profits implicit item. His analysis of the request stated:

> "Whilst there is still some debate at the margins between the company and GAD relating to the precise reserve for the GAOs, we are generally satisfied that the company is adequately reserved for this exposure. The reserve for the GAO exposure has been largely offset through reinsurance.
>
> The company does face the threat of an appeal to the original Court Judgement on the GAO issue at the end of this month. It is also possible that other cases may be brought in the future relation to the differential terminal bonus treatment. However, any Court decision on this issue should not effect the financial position of the Equitable as shown in the HMT Annual Return since our Regulations require the company to reserve fully for all GAO policies in any case.
>
> The Equitable have provided the detailed calculations in relation to Regulation 24, and the company could have qualified for an implicit item of almost twice that which has been applied for. The calculations have been reviewed by the GAD and they are content that the concession should be granted."

The order was issued and sent to the Society on 9 November.

<u>View taken on conduct of business implications</u>

29. At about the same time, the conduct of business regulators were considering the bonus notices. Roberts e-mailed them on 15 September and concluded that despite the appeal, any analysis should not await its conclusion (albeit any action would probably have to await the decision). On 23 September the senior line supervisor was told that her conduct of business colleagues had concluded that the bonus notice for 1998 was not poorly presented or inaccurate, and in order to take action on a document concerned with the on-going service of policies the conduct of

business regulators would "have to have serious concerns". An internal memo demonstrated that they had concluded there was "nothing seriously wrong" with the notices for 1997,1998 and 1999. The senior line supervisor took the 23 September memo as a general endorsement of the Society's practices. Indeed she commented on its face that it was a "surprisingly unqualified endorsement for the bonus notices".

30. These documents made it plain that the notices, relating as they did to the on-going servicing of a policy, did not appear to the conduct of business regulators to fall naturally into their remit. The implication was that a document of central importance to the policyholder, not only in relation to accrued benefits but also in relation to decisions whether to invest further with the Society, could be subject to such uncertainty within the framework of the existing regulatory framework. There was no suggestion that the findings should have triggered a major review of the regulatory system. The conduct of business view was accepted without further debate despite the senior line supervisor's view, supported by Ford in the summary of the judgment, that the notices were potentially misleading, and secondly, that the prudential regulators were in possession of the Society's own legal opinion which recommended changes to the forms in use down to 1997. The view had also been reached on review of a limited range of documents.

View taken by GAD on PRE

31. On 1 October the scrutinising actuary wrote to FSA to offer his view why the September judgment meant that the Society's current practices were not contrary to PRE (in contrast to Ford's view in her 10 September summary). He quoted a number of passages from the judgment that, in his view, distinguished the bonus notice and other material issued before and after 1994, and concluded that the implications for the FSA as set out by Ford were "not totally valid". He said:

> "On the basis of this judgement, it would seem to me that sufficient or due regard was and continues to be given to PRE."

The Vice Chancellor's conclusion had been that:

> "I am not satisfied that the Society failed, when exercising its discretion regarding final bonus over the period since 1994, to take into account PRE."

This provided a measure of support for the scrutinising actuary's argument. But it was not based on a full analysis of the requirements for an effective change of established expectations.

32. On 29 October the senior line supervisor wrote to Headdon about the number of GAR policies sold between April and June 1988 (the short period during which the sale of these policies overlapped the new conduct of business regime under the 1986 Act, on the conduct of business view of its jurisdiction) and the number of existing GAR policies which had been 'topped-up' since April 1988 (specifically whether such top-ups had been made in 1994 and more recently). The problems of additional contributions under existing policies had been indirectly highlighted to the regulators by the Society for the first time through the March 1999 board paper sent to them on 20 April 1999[3].

33. Headdon replied on 10 November 1999 saying that the first question could be answered relatively easily, but querying what was meant by topping-up. In the letter he also mentioned the upcoming visit and notified her that the Court of Appeal hearing would take place on 29 and 30 November. In preparation for the visit FSA requested further information from the Society on 15 November, including the latest financial condition report, details of corporate structures, the latest report from the investment manager and various internal audit documents. Headdon responded on 25 November, reminding FSA that there was no financial condition report as such,

[3] See chapter 17, paragraphs 133 to 136.

but enclosing various financial projections, structure charts, investment policy documents and the like.

34. On 26 November the senior line supervisor responded to the top-up query by saying that she wanted to discuss the usefulness of such information with others before she asked Headdon to go any further (which she did that day by memo to the conduct of business regulators). On 3 December Headdon supplied the information that over 22,000 retirement policies with annuity guarantees had been written between 29 April and 30 June 1988. The senior line supervisor passed this information on to her conduct of business colleagues on 12 January 2000, at which time she seems to have concluded that the top-up issue might not be worth pursuing.

35. The issue of the Society's GAR take-up rates was due for discussion at the upcoming December meeting. On 24 November Ford was sent a general paper on the subject by one of her fellow legal advisers (which he had prepared in the context of another company's annuity problems). The undated paper[4] suggested that, while the prudential regulators had considered at the time of the guidance that the maximum reduction on take-up rates should be 5%, some companies had interpreted them as allowing 10% (with the Society assuming 20% and one other company 30%). The paper continued:

> "As yet no action has been taken to criticise the standard of reserving adopted by any of these companies. There is a need to settle the FSA's policy in this regard..."

The paper went on to state:

> "We would not expect companies to file revised returns for 1998 where they had reserved below the 95% level in those returns. This is in line with our general practice of not requiring returns to be resubmitted where concerns over the appropriateness of the reserving basis are limited to particular areas of the valuation. Therefore Equitable and others would not face embarrassment in this regard and the increased level of reserving in 1999 would probably escape public comment."

36. Ford queried the figure for the Society with the senior line supervisor. The latter responded that FSA had queried the Society's approach, but had not yet expressed a view on the justification they had provided. She stated:

> "We knew they would go for as high a figure as they thought they could get away with."

Ford responded by suggesting that the paper implied that the 1998 returns had been accepted, or that a decision had been made to do nothing about them. It seems therefore that the failure to confront the Society in a timely fashion about their take up rates was reflective of the FSA's approach to a number of companies.

37. The Court of Appeal hearing took place between 30 November and 1 December 1999.

December 1999 Meeting at Aylesbury

38. The 6 December 1999 meeting at the Society's Aylesbury offices was attended by the two FSA line supervisors, the principal and scrutinising actuaries and Nash, Headdon, Thomas (the investment director) and the general manager, sales and marketing, from the Society. A college of regulators' meeting on 26 November had recorded that the supervisors intended "to fill in some of the gaps in its knowledge about the Society" at the visit. The minutes recorded that a wide variety of topics were discussed, most of which do not need to be rehearsed here, but two topics of direct relevance were discussed:

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[4] The paper did not show an author, but seemed to have been prepared for a meeting of the Insurance Supervisory Committee (ISC).

i. The issue of GAR reserving was taken up and the senior line supervisor announced that the Government Actuary would be writing to all companies to clarify his January guidance, which could mean that Equitable would need to increase its reserves.

ii. Equitable recognised the need to cut guaranteed bonus rates further but wanted to pause before any further cuts to see if yields would improve. However if reversionary bonuses remained at 5%, terminal bonuses were likely to be pushed up because the company would be allocating less than it had earned for the last 4 years.

It had thus taken nearly 10 months for GAD and the FSA to decide to clarify the reserving guidance, leaving the possibility that the 1998 returns (as well as the 1997 returns) showed reserves for the annuity guarantees which were thought by the regulators to be inadequate. Hewitson e-mailed the senior line supervisor on 16 December (although she obviously already knew by then) to say that clarifying guidance was to be issued

> "... following our review of the actuarial bases adopted... in 1998 returns, and some comments received here about possible inconsistencies in the assumptions made."

39. A draft of the covering letter to all managing directors was circulated on 20 and 21 December. In this draft Allen made explicit that while FSA would not now require resubmission of 1998 returns, any failure to comply in 1999 returns with the guidance, without a satisfactory justification, might well lead to publication by FSA of the fact that a lower standard had been adopted by the firm. However on 22 December Allen changed his mind:

> "After sleeping on this I favour a shorter and simpler covering letter which does no more than draw CEO's attention to the GA's guidance. This achieves our objective of clarification, and avoids raising questions of possible future intervention which may not otherwise arise, and some of which I think would need to be brokered more widely within the FSA if we wanted to trail them in this letter..."

Ford warned that any failure to mention possible intervention would make it "harder and perhaps impossible" to publish in the way outlined.

40. The final version of the letter together with the guidance was sent out on 22 December 1999. The letter merely introduced the guidance and requested that companies contact Allen if any difficulties in complying were foreseen. The guidance itself indicated that a few % points should be taken to mean a total aggregate allowance of no more than 5% of the reserves.

The Court of Appeal Judgment

41. The Court of Appeal delivered its judgment on 21 January 2000 and ruled by a majority that the Society's differential final bonus policy affecting the annuity guarantee policyholders was not permissible. The application of the judgment was suspended pending appeal to the House of Lords.

42. Davies was concerned about a press report the next day which suggested that the FSA was thought by others in the industry to have been indulgent towards the Society. Roberts refuted this and challenged Morritt LJ's reference (in his dissenting judgment) to the December 1998 PRE guidance letter as endorsing the Society's differential terminal bonus policy. In reference to the guidance he stated:

> "We are reviewing the letter but at first glance it doesn't seem too bad even in the light of the Court's judgement. But this may have been picked up as an indication of indulgence."

Hewitson thought that most, but not all of the December 1998 advice could survive, and considered that all companies might well have to be written to again. Roberts' comments in particular now seem rather optimistic, if not defensive. Morritt LJ's opinion warranted a more thorough assessment. His comments reflected what most objective readers would have made of the guidance. Roberts has commented in his maxwellisation observations to the inquiry that his reply to Davies' question was immediate and accurate, and did not pre-empt a full examination of the judgment. I have reflected my own impressions in my comments.

43. Both Ford and Roberts felt that any evaluation of the judgment might be premature given the appeal to the House of Lords. Ford's 31 January summary of the judgment noted that each Judge had given different reasons for his decision and that it would be impossible to predict the outcome in the House of Lords. The summary also mentioned Waller LJ's 'ring fencing' comment only in the very brief terms that he had concluded that "...different bonuses might be awarded to different types of policyholder (e.g. GAR policyholders)...".

44. The senior line supervisor phoned Headdon on 25 January, asking about the Society's fall-back position and requesting to be kept in touch about contingency planning. According to his note, Headdon gained the impression from the call that the FSA would have no PRE concerns, as long as there was a route by which the substantial majority of policyholders could realistically have benefits of similar value before and after a change.

45. The Society wrote to policyholders on 1 February informing them that the High Court decision had been overturned, but offering the reassurance that there would be "no significant costs imposed" if this decision were upheld by the House of Lords. Any speculation about financial difficulties was said to be unfounded. The letter was to become a focus of controversy.

46. In response to the judgment the senior line supervisor wrote to all affected companies enquiring as to their current bonus practice. Foot reported to the FSA Board on 17 February that the Society did not appear to face any immediate financial risk or any additional threat to its independence and that even if the judgment was upheld "potentially the new approach need not lead to significant additional costs". On 22 May the senior line supervisor offered the opinion that "[The Society] are not the strongest life office you will find but nor is there an immediate prospect of them going broke (even if they lose in the House of Lords)".

47. In short, the adverse judgment was not seen as affecting materially the Society's financial position, and very little was done by FSA in relation to the court case between the Court of Appeal judgment in January and whispers of the possible outcome in June and July of the House of Lords' hearing. There was no updating of the earlier scenario document (prepared for the High Court hearing) until the day before the House of Lords' judgment. On 31 May 2000 FSA were sent a copy of the agreed statement of facts for the case by the Society's solicitors who added that they had not provided a copy of Hyman's case because his solicitors had not indicated their consent. The senior line supervisor noted to Ford on the face of this letter:

> "Having discussed this briefly with [one of the legal advisers], I do not propose to approach Norton Rose direct for a copy... as the reasons we would need to give for wanting the papers might suggest we would/could do something depending on the outcome of the case. I would not want to generate this expectation and I do not see problems in waiting until the case comes to court and the document thus becomes public."

The hearing began on 12 June. On 27 June the Society applied for a future profits implicit item of £1.1 billion for 2000 and on 30 June the returns for 1999 were submitted.

The House of Lords' Judgment and the Closure to New Business

48. The House of Lords' judgment was delivered on 20 July, 2000. However, as mentioned in chapter 1, Foot at the FSA was called by one of the Society's two deputy chairmen on 4 July and warned that the Board of the Society now believed that they might well lose[5]. In response to Sedgwick's report that there was concern among the Board as to "what level of sacrifice" might be needed at the top of the Society, and having spoken to Davies and Roberts, Foot assured Sedgwick the following day that the FSA was anxious to ensure continuity amongst the executives (with any necessary resignations at the end of the year), and that

> "It would of course depend upon the material in the Judgment, but on what we knew so far it was unlikely that the FSA would be throwing brickbats at Equitable Life."

49. A meeting took place between the FSA, GAD and the Society on 18 July (at the Society's request according to the Baird Report). The minutes record Nash outlining a new scenario which had apparently not previously been formulated as an independent possibility, but which could now be identified in light of the hearing:

> "A ruling that did not allow the Society to alter the bonus for policies that contained GARs - the Society would need to declare a rate of bonus as if the policies did not contain GARs. This would mean that the Equitable would have to pay a GA on top of the unadjusted asset share; the directors of the Society would not be able to adjust bonus rates downwards because GAR benefits gave an additional benefit to the policyholder."

Although this scenario was still thought unlikely, if it emerged, it would have "severe consequences for the Society", "a profound effect on solvency", and would invalidate the reinsurance (he noted that the Society had not sought reinsurance cover for this eventuality, and that it had been Headdon's opinion that it would not have been a viable proposition). If this was the outcome, Nash indicated that the Board had decided to announce that the company would seek a partner. Headdon did not think the company would be insolvent on the additional scenario but was still assessing the situation. It was minuted that:

> "Mr Nash was keen to avoid any precipitous action from the FSA in light of this adverse judgement. Mainly because this could have a detrimental effect on the value of the business, for example stopping the company writing business could lead to losses in the field force and this was a valuable asset for the society. Similarly a need to rush into gilts could also have detrimental effects.
>
> Mr Allen reassured the Society that we would not rush to take remedial action in these circumstances and understood the importance of maintaining the value of the society. We would, however, need to be convinced that a suitable buyer for the Society was likely to be found quickly. Mr Headdon thought that if the Society was forced into this course of action it would be able to begin substantive sales negotiations with a number of potential partners in August with a view to completing the sale before the end of the year."

50. It is difficult to reconstruct the atmosphere at this stage. There appears to have been a growing appreciation that the Society's lack of room to manoeuvre was a product of marketing and distribution decisions taken over a long period of time. Chamberlain summarised his view of the situation (in hindsight) for the inquiry as follows:

> "The way Equitable presented results, especially as between policyholders with and without GARs, was apparently identical although a small note was tucked away at the end of the bonus notices. The Equitable managed to restrict their freedom of action without intending to... The Equitable's 1989 change of

[5] See chapter 1, paragraph 116.

> declaration style caused this issue to arise, ironically, because although most GARs were stopped in 1988 this was when the Society created the guaranteed and non-guaranteed bonus structures to make everything look the same."

The additional scenario recognised that there was no method by which the Society could meet the cost of annuity guarantees through bonus allocations, and in particular that no ring-fencing method could be devised for that purpose by the Society because of their presentation of all policies as carrying equal benefits (as touched upon by Chamberlain above) and because of the method by which they had chosen to meet the cost of the guarantees from final bonus.

51. The Society's view of the worst-case scenario may have influenced FSA's understanding of what that scenario actually implied, but it is unlikely that FSA had at that stage the depth of knowledge to appreciate how Equitable was constrained by past practice and presentation. There had not been a comprehensive survey and analysis of the relevant material by regulators or GAD. They did not have the material that has been uncovered by this inquiry and is dealt with in chapter 14.

52. The early indication given at this meeting of a sympathetic approach from FSA (reflected also in the 5 July phone call from Foot to Sedgwick) and the acceptance that it was appropriate for there to be a degree of co-operation between the Society and the regulator en route towards a sale, in preference to regulatory intervention, for example by imposing closure to new business, was also to set the tone of what was to happen over the next five months.

53. The day before the judgment the senior line supervisor circulated a new scenario document which set out the additional scenario, described as:

> "Equitable lose very badly. Different level of terminal bonus may not be paid according to whether or not a policyholder takes advantage of his [GAR] and the existence of GARs in a class of contract should not influence the level of bonuses paid to that class of contract."

The document added to what had been said at the meeting on this outcome that, even if the solvency margin were breached, it would be unlikely that FSA would need to take action, since the Society would already be taking steps to ensure the financial situation was repaired.

54. On 20 July the judgment was delivered. On the same day the Society announced its intention to seek a buyer. Ford prepared a summary that day (with the promise of a longer note to follow) which set out the basic tenets of the decision, although it did not specifically mention Lord Steyn's rejection of Waller LJ's ring-fencing comment. Ford described the decision as "the worst outcome" for the Society and warned that the position would have to be considered very carefully (particularly vis à vis the other companies effected).

55. Rathbone commented on the summary the same day to the senior line supervisor that it "had underestimated the implications of the judgement in respect of the "ring fencing" issue, which could be wide ranging beyond the GAR issue", a fact to which the senior line supervisor was already alive. She had spoken to Headdon who had notified her that the Society intended to make an immediate 5% cut in with-profits policy values across the board. The extent to which the judgment affected other life offices' practice was to become, and remains, controversial in the industry. But the regulators and GAD were to remain of the view that it had general application.

56. A fuller note was circulated by one of the other legal advisers the following day, which expanded on some of the issues touched upon in the shorter version and added a section dealing with the 'ring-fencing' issue. This repeated almost verbatim what Lord Steyn had said in his rejection of Waller LJ's proposal but offered no analysis thereof. No direct advice seems to have been obtained by FSA at this stage about the interpretation and scope of Lord Steyn's comments. There was discussion of the topic in late August 2000 within various FSA e-mails triggered by the

circulation of a draft of a new guidance letter. Allen commented that a section of the draft guidance, which talked of purpose versus practical effect, looked a bit like an attempt to get round the Lords' judgment.

57. The senior line supervisor responded, noting that:

> "The judgement came out against ring-fencing on the basis that it was being used to undermine the benefit of the guarantee. Strictly therefore the judgement does not rule out ring-fencing for other purposes."

However, in practice neither she nor the legal adviser had been able to think of a bona fide reason why companies might ring-fence, though that did not mean that others would not be able to. They had included the passage referred to by Allen to discourage companies from thinking this was an easy way round the judgment, and to make them aware that if the practical effect was to reduce the value of the annuity guarantees, they would have to "work particularly hard" to show this was not the purpose of the ring-fencing. She conceded that the drafting might be too subtle to get this message across. She continued:

> "I see the biggest area where we could be sticking our neck out as the last paragraph in the section on PRE where we say companies can make a charge against the asset share for the cost of the guarantee."

She noted that a number of companies had suggested that they thought this should be acceptable, but one had received advice that suggested otherwise. She concluded:

> "It appears to me if you can't make such a charge, current actuarial thinking on the operation of WP policies really is rather shot to pieces."

58. On 24 July Rathbone confirmed to FSA that the judgment should have no effect on the level of insurers' reserves (besides the Society) and commented that it justified the "tough stance" taken. He continued:

> "In retrospect [the Society's appointed actuary] is shown to have acted imprudently in taking credit for the reassurance. No doubt he was relying upon the Board's view, based upon legal advice, that they were unlikely to have to change their bonus policy."

59. On the same day an action plan was circulated within FSA and copied to Rathbone. In relation to the Society, it was said that the FSA should confirm its solvency position and review its financial projections. Discussions were to be held with the Society "regarding the processes that will be involved in taking forward a sale". It was suggested that Roberts chair a meeting with them to encourage the Society to maintain a close dialogue with the regulators on the subject.

60. Looking at the wider impact, it was agreed that FSA should write to all other companies given the potentially wide implications of the judgment (going beyond annuity guarantees) and ask for their assessment of the judgment on their business. A further careful look would need to be given to the twenty-five companies identified in the survey who either operated a differential terminal bonus policy or ring-fenced (in whole or part) the cost of the guarantees amongst GAR policyholders to see whether they would need to alter their bonus practices. Meanwhile the guidance issued to firms would need to be reviewed. Approving the plan, Roberts instructed that companies should be told not to rely on the December 1998 guidance until it had been reviewed.

61. The plan did not indicate that any queries were being raised about the extent of any ring-fencing prohibition; nor that any debate was to take place about alternatives to the sale route proposed by the Society; nor that thought was to be given to the position of those people who might choose to take out a policy in the period following the judgment. The plan seems to indicate that FSA were confident about the success of any sale process, an impression confirmed by an e-mail that same day from the senior line supervisor:

"In relation to the sale. I don't think you could say it is 100% certain but it must be close to 99.9%. The company see a sale as the only option and as far as I can see the only reason it would not go ahead would be if there was no suitable buyer and that appears unlikely."

Foot reported to the financial stability standing committee[6] on the same day:

"Mr Foot said that there would only be real problems if Equitable Life could not find a buyer by – say – the end of the year. But, currently, that problem did not seem at all likely to emerge."

62. Roberts has told the inquiry:

"Equitable were putting together a plan to sell the business. This was a reasonable – although not the only possible – approach, and one which offered the prospect of restoring value to the policies of those policyholders who had lost out as a result of the House of Lords judgement. I thought it would sell, based on our knowledge and the high regard of the market for Equitable."

The observations reflected FSA's contemporary understanding of the Society's financial position, derived from the system of supervision in force and in particular from the Society's returns. From observations that have been made since, it is not clear that the market did share a high regard for the Society: it was to become clear that due diligence investigations focused on and uncovered the weaknesses discussed in chapter 6 [lifting the veil].

63. In the event, confidence in the prospects for a sale was misplaced. But it was to be the keystone to FSA's approach over the next few months, and the basis of regulatory decisions during that period relating in particular to new business sales and collection of additional premiums and contributions from existing policyholders. Allen has told the inquiry that the financial position was not the only factor underlying the failure to find a buyer: but it remains my view that the regulators' inability to make an independent and reliable assessment of the Society's financial position from information gathered through the regulatory process at this critical stage was a serious impediment, and is a further indication that there are serious issues about the effectiveness of regulation generally at that time.

64. On 26 July Headdon wrote to FSA with figures on the current estimated solvency position which reflected a cover factor over RMM of 1.18x and free assets of £225m on the old resilience test applied in the aftermath of the judgment. The reinsurance arrangement remained in force for 3 months beyond the House of Lords' decision, and the Society was discussing the possibility of an amended treaty with a higher take-up threshold. Headdon noted in summary:

"On a continuing basis the position would be unacceptably weak. However, as you said last week, we have effectively implemented a plan to strengthen the position by taking the course of action we have. Meanwhile I believe it is reasonable to regard the society as continuing to meet its required minimum margin."

On 4 August he wrote again to assure FSA that new business would have no material impact on the immediate ongoing solvency position.

65. Meanwhile, on 26 July 2000 FSA produced a series of answers to questions faxed by the Treasury on the day after the judgment about the scale of the problem, the wider impact and the way matters had been handled. In response to points the Treasury had put under the heading 'Did the regulator get it right?', the FSA brief said:

[6] The standing committee consists of representatives of HM Treasury, the Bank of England and FSA, and was established under a memorandum of understanding between the Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the FSA. It was established in 1997.

> "On balance we did not do badly and indeed it would have been difficult for any guidance to have been consistent with the full range of different judgements that have appeared... The [PRE] guidance... will need to be reviewed, but it is not clear that it was 'wrong'... we could not reasonably... anticipate the [House of Lords'] ruling."

66. On 27 July 2000 FSA wrote to all with-profits offices, suspending the guidance issued in Roberts letter of 18 December and asking for the implications of the judgment on their business. A rather more detailed letter was sent to those thought to be more directly effected. As I have commented elsewhere, litigation is never an exact science, and anticipation of the result of a dispute can often be speculative. The question that regulators and GAD failed properly to address was not whether the actual result should reasonably have been anticipated, but whether the outcome was within the range of possible results for which contingency planning should have been in place so as to instruct their enquiries and supervision over the material period. As discussed above, the possibility of failure was included in the list of scenarios, but that did not lead to significant planning for the event.

67. Various discussions followed from July through to November 2000 about a new guidance note (which appeared initially to be thought necessary in light of the confusion companies had expressed over the judgment in reply to the 27 July letter) but none was issued. The minutes of an internal meeting on 17 October record the conclusion that FSA should not close off the possibility of either FSA or the industry going to court to obtain clarification (an option apparently being considered by one life office at the time). Such was the apparent uncertainty that Andrew Whittaker, the FSA general counsel, hosted a conference on 1 November about the implications of the judgment. In the event, no further application was made to the court.

68. On 11 August 2000 a meeting took place at the request of the FSA "to discuss the regulatory aspects of the sales process". As well as the regulators and Nash and Headdon from the Society, it was attended by the Society's advisors: Ernst & Young, Lovells and Schroders. During the meeting the Society provided details of the sale process and its timescale (a finalised purchaser by the end of December 2000 and a completed sale by June 2001). Roberts commented that the timetable was tight and that while FSA would give the sale priority, there were limited resources.

69. There was also discussion about the Society's financial position. Headdon explained that a renegotiated reinsurance treaty, which would give cover when there was more than a 60% GAR take-up (increased from 25%), was close to being completed (it was in fact signed on 22 August). Despite this the figures (based on the old resilience test) still showed a relatively low coverage of the RMM (a cover of 1.32x without allowance for reversionary bonuses). Roberts agreed to have a look at the Society's proposals for compensation and the Society agreed to supply FSA with monthly solvency figures from then on (which they did).

70. Save on the subject of the draft guidance note, there was relatively little FSA activity for the rest of August and into September. GAD indicated that they had no questions on either the solvency figures or the reassurance addendum, both of which were supplied by the Society on 1 September.

<u>Future profits implicit item for 2000</u>

71. On 1 September 2000, following consultations with GAD, the line supervisor wrote a paper recommending approval of the Society's 27 June application for a £1.1 billion future profits implicit item order for 2000 year-end. GAD had recommended approval of the order on 7 July, but had noted that the Society's disclosure was "sparse" in places and that there were some odd features of the calculation. However, the Society had applied for only a third of what they could have applied for based on their assumptions, and GAD were satisfied that "the surplus quoted is not being materially bolstered by running down the reserve". In his analysis, the line supervisor noted that these orders had been routinely issued in the past, and that the calculation produced a conservative estimate of future profits emerging from the

in-force book of business. On the basis of the figures reproduced in table 18.1 below, he advised that the Society was unlikely to be dependent on the implicit item for coverage of the RMM.

Table 18.1: Equitable end June 2000 figures (£m), restated post-Judgment

Net explicit assets	1580
Current future profits item	1000
Total assets to meet RMM	2580
RMM	1190
Excess assets	1390

The line supervisor noted that the particular circumstances of the Society required careful consideration, but the uncertainties involved (he cited a reduction in long-term interest rates as an example) should not significantly affect the future profits calculation. The calculations had been approved by GAD, who were "fully aware of the context in which this concession would be granted". He noted that HMT had agreed to issue the order[7].

72. It may be true that the uncertainties surrounding the Society by this time were not likely to affect the calculation under regulation 24, which was essentially backward-looking, but it does raise the question of how they affected the view taken, looking forwards, of the likelihood that these profits would emerge from the in-force business. In that context the paper did not set out any financial analysis, and placed considerable weight on the appointed actuary's certificate that would have to state that the profits would be available. This was one of the fundamental weaknesses of the future profits implicit item, but in the specific circumstances of the Society at the time one might reasonably have expected that more would have been done to test the assumption that the profits would emerge.

73. Indeed a comment made on 14 May 2001 by a newly appointed senior line supervisor for the Society in a note to HMT about the 2000 returns offers an interesting insight. He discussed some concerns that had been raised about the 2000 valuation, including the section 68 orders for future profits and the subordinated debt. He remarked:

> "Inevitably, as concessions are disclosed in the annual returns, some commentators will suggest that while individually the concessions may seem reasonable, ... collectively it could be argued that the Society has been permitted to elect the most favourable valuation basis on each occasion. Our view is that such criticism would be unfair because we have worked hard with the company to improve the reliability of its financial reporting; and the effect has sometimes been to increase the level of reserves required."

As should by now be clear, I take the view that the Society were indeed permitted to elect the valuation basis on each occasion, even if this had not been an explicit policy of Ranson's from an early date.

Advertising

74. At the start of October FSA received a complaint about the Society's recent advertising, but the conduct of business regulators did not consider that the adverts needed to be withdrawn (in part on the basis that the company had been successful for many years and the annuity guarantee issue did not totally overshadow that fact).

[7] The order, which was signed by HMT and sent to Headdon on 13 September, was for only £110m. Although the Society was reminded that the amount of the implicit item included in form 9 of the returns for the year-end could not be greater than would be supported by the figures in those returns, and that this might well be lower than the £1.1 billion requested, the reduction to £110m appears to be a simple clerical error.

75. The complaint about advertising highlighted the absence from the available documents of any record of discussion thus far about the situation of incoming policyholders. Nor did this complaint appear to prompt discussion. A further complaint about advertising was forwarded to the prudential regulators at the end of October and this did lead to some discussion. On 3 November a newly arrived member of the team e-mailed Allen about the complaints and observed:

> "I am not sure we can say much more other than the company is solvent so why should it not advertise... I do not see we can say much else unless we thought we had grounds (and were intending) to use intervention powers to stop the firm writing new business."

Allen responded by approving the draft letter supplied, which said that as the company was solvent and not in breach of regulatory requirements, the FSA was not of the view that it should be prevented from marketing its products. Even this exchange, therefore, did not include or lead to any formal consideration of the wider issues concerning the FSA's responsibilities to those joining the fund and as to whether there were any mechanisms by which new policyholders' interests might be protected either by the Society or by the regulator. Despite the terms of the draft letter, it appears that someone from the FSA did, however, phone the Society about the adverts, following which they were scaled down.

The Sale Begins to Unravel

76. On the 9 October the Society supplied further monthly solvency figures and a letter that had been sent to policyholders about the Society's proposals to provide compensation for those whose benefits on maturity had been or might have been affected by the differential final bonus policy, the beneficiaries of the 'rectification scheme'. On this occasion there was an expression of some concern from GAD. It was pointed out that if equities fell by 15% from the position at end-August, the Society would not cover its RMM, and that in light of recent falls in the FTSE-100 index, this ought to be closely monitored.

77. On 19 October the FSA Board were told that the Society had received three serious offers to buy thus far. That day the FSA supervisors and their GAD advisers were involved in a meeting with one of the potential bidders. The bidder sought information about FSA's expectations about proposals relating to the possible decline in interest rates and the interaction of interest trends and PRE. Allen is reported to have pointed out that:

> "... at present there is no definition of PRE, however policyholders have expectations regarding bonus returns. Maintenance of trends is an important part of PRE but that doesn't mean that bonus rates cannot go up or down, it does depend on whether the change in those trends is foreseeable. [The potential bidder's] offer may want to take account of an interest rate reduction but we cannot require this."

Allen has told the inquiry that the supposed lack of 'definition' of 'policyholders' reasonable expectations' was not relied on as a reason for not intervening. He did regard the lack of definition as undesirable, but said that, in other circumstances, this had been exploited by him and other regulators to press for action.

78. On 1 November 2000 Roberts was phoned by another of the potential bidders. By now there had been a number of negative press reports about the value of the Society and the bidder wished to assure FSA that this did not reflect some attempt by the bidder to "talk down" the price. However, the bidder was:

> "... becoming increasingly concerned about the financial implications of a deal. The more work they do in the data room the more they are convinced that the scale of the shortfall in the Equitable's funds is greater than the Equitable themselves estimate."

The caller also raised the problem of top-ups to existing GAR policies and whether this liability could be capped in any way. The top-up issue had been considered by the senior line supervisor in a rather different context during October and November 1999, but appears to have been taken no further after January 2000 so far as the record shows. The Society's March 1999 board paper (sent to FSA on 20 April 1999) had highlighted the liability problem posed by additional contributions (and suggested ways to discourage policyholders from making them), but apart from some comments by the scrutinising actuary on the proposed methods of discouragement, the issue was not developed. The caller's intervention caused some concern in FSA.

79. Roberts contacted Hewitson about the problems raised. Hewitson responded by e-mail on 2 November, saying that Headdon had confirmed that further premiums could be paid on existing policies. Hewitson suggested that it might be possible for FSA to prevent the Society from accepting more than a certain amount of incremental premiums on annuity guarantee policies. His comments were:

> "One possibility (that we could discuss with Equitable at some stage) would be to issue an Order preventing them from accepting more than £ X million incremental premiums on GAO policies. This would certainly cap the liability and we could seek to ensure that they were fully reserved for this amount of future premiums. This would be much less dramatic than a full stop order which would almost certainly kill their chances of a sale to a third party."

He offered no ground on which such a step might be taken, and proposed it without reference to his understanding of the terms of any contract in force. The proposal amounted to a suggestion that regulators should use their powers to procure a breach of Equitable's contracts with its annuity-guarantee policyholders.

80. A meeting with the Society about reserving issues was already scheduled for 3 November. According to the FSA minutes of the meeting, Tim Roff of Ernst & Young confirmed that he

> "... had looked at the sensitivities involved concerning the likelihood of GAR policyholders increasing their benefits and felt comfortable with Equitable's figures. He understood why potential purchasers would be worried by this potential exposure, but thought that once the basis for reserving was further explained some reassurance had been given to bidders."

It was also reported at this meeting that a valuation report by Ernst & Young had been supplied to all potential bidders and FSA asked to be provided with a copy.

81. After the meeting Hewitson wrote his own note of it. This recorded in more detail than the FSA minutes that an academic[8] was suggesting that the House of Lords' judgment was being interpreted too widely, and in particular that it did not preclude ring-fencing generally. But he recorded that the Society "seem to have persuaded him for the time being that his argument is flawed". The note also recorded that the Society had been advised that it could not withdraw the option to pay further premiums without giving adequate notice to the policyholder (which it thought rather negated any possible advantage in adopting this course). The Society was apparently of the view that the issue would not be a serious concern to potential bidders. Hewitson's note concluded as follows:

> "We believe that the society is covering its minimum capital requirement at present but has very little room for manoeuvre in the event of even a modest fall in equity values. The management seem to accept therefore that they have no alternative other than to arrange a sale and demutualisation if they are to remain open to new business. With the recent cut in bonus rates (and assuming this is not reversed), new policyholders should not have to meet any cost of the GARs, as indeed is their likely expectation. However, they will be joining a very weak fund.

[8] Jeremy Lever QC, dean of All Souls, Oxford, see discussion of rectification scheme in chapter 8.

> If the sale does not take place, then we shall almost certainly have to lean on them to stop writing new business, and they will probably also need to rearrange their investment portfolio to a more defensive position. Otherwise a full liquidation could be envisaged in the event of a substantial fall in equity values."

It so happens that this bleak portrayal of the prospects for new policyholders was written on the same day that Allen approved the draft letter declining to intervene to prevent the Society advertising. Allen has told the inquiry that he had not seen Hewitson's note when he approved the letter, and that even if he had, it was still justified by the rationale for the stance on advertising.

82. As mentioned already, FSA met another potential bidder on 6 November[9]. This bidder raised a number of difficult questions about the Society's overall financial position and solvency, and whether the bidder could count on the regulatory benefit of the future profits implicit item and the subordinated debt. Interest was expressed in the regulators' views on financial reinsurance, for example, secured on future margins. When FSA and GAD said that they would not support arrangements based on "regulatory arbitrage", the actuarial consultant to the bidder observed that the Society's existing arrangements fell into that category. It has been represented to me in the course of maxwellisation that FSA did not believe that the reinsurance treaty was regulatory arbitrage in the sense that the Society was seeking to take advantage of a less than stringent regulatory regime in a different jurisdiction. Further it has been represented that the reinsurer was financially strong and a subsidiary of GE Capital. If these representations reflected FSA's views at the time, one might have expected the bidder to be assured that the arrangements Equitable had entered into could be continued. I was not persuaded that FSA's observations were other than reflective of a wish to ensure that the Society's reinsurance scheme was not continued.

83. On valuation, the actuarial consultant asked why the Society effectively added ½% p.a. to the investment return in the resilience scenario. He was questioning the regularity of the quasi-zillmer adjustment (which was discussed in the Ernst & Young report, which the FSA and GAD still had not seen). The note of the meeting recorded that FSA had not been able to answer the questions put, partly because the information sought was confidential to the Society, and partly because they had not had advance warning of the quasi-zillmer issue. But the questions served to focus a range of issues relating to the Society's financial position. As indicated earlier the scrutiny process relating to the 1997 and 1998 returns had not identified the quasi-zillmer issue.

84. The picture did not improve and by 10 November one of the bidders had pulled out because:

> "They had reached the view that the Equitable's financial position was considerably worse than they had first thought. The hole was significantly larger than they had expected."

Roberts' note of his conversation with the bidder recorded that the bidder had explained that his motive in calling "was to alert me to the fact that Equitable's position might be rather more doubtful than we had been led to believe".

85. On 14 November an internal FSA paper (copied to GAD) addressed the possible outcomes to the process, including the possibility that there were no bidders. In the 'no-bid' scenario the author concluded that consideration would have to be given to intervention (if the power to intervene existed in the circumstances) and that:

> "We would in particular need to carry out a fairly robust analysis of the company's financial position, for example to check the basis on which the accounts and financial statements have been prepared, so as to ensure that

[9] See chapter 7, paragraph 85.

> assumptions and projections remained valid for a radically different business model."

The paper also considered ways in which the GAR top-up liability could be capped, an aspect which it was acknowledged had bothered some of the bidders.

86. Hewitson responded to the paper by saying that if no bidders remained an independent investigation of the Society's viability to write further business would have to be commissioned.

87. The next day one of the bidders who had indicated already that they were unlikely to bid called Foot and told him that "due diligence had left him feeling that it wouldn't be worth taking the Equitable at any price". Davies noted that "the prospects look dimmer by the day".

88. On 15 and 16 November FSA met the two remaining bidders, both of whom still appeared to be genuinely interested, but one of whom remained concerned about the "open ended nature of the [GAR] liabilities". On 16 November Headdon finally provided Hewitson with copies of the three reports prepared by Ernst & Young (which had been promised on 3 November). These reports revealed the existence of the ½% quasi-zillmer adjustment that had been raised by the potential bidder on 6 November. In the letter which enclosed the report Headdon described this adjustment as having been "a topic of discussion with some of the purchasers in recent days" and he proceeded to attempt to justify its use to Hewitson in the following way:

> "As I mentioned when we met, the Society's recurrent single premium contract is somewhat unusual... and has never fitted the valuation regulations, which have been essentially based on a net premium valuation of level premium contracts, particularly well. As such, over the years, a certain amount of interpretation has been needed to determine minimum reserving requirements, particularly in resilience test conditions.
>
> In particular we have included an allowance for unrecouped acquisition costs consistent with the spirit of regulation 68, which necessarily takes the form of a reduction in benefits. It has been my understanding that that was something discussed with GAD when my predecessor, R H Ranson, introduced the practice in the early 1990s. From the files I have inherited I cannot find specific correspondence on the topic but note that meetings were held in September 1992 and November 1993 when detailed discussion of the approach to resilience testing was a major item on the agendas. From 1996 Returns onwards, following new regulations requiring greater disclosure of the approach to resilience testing, the approach has been described in Schedule 4 each year... For clarity I should confirm that the approach is only taken on contracts where future premiums are payable. True single premium products such as bonds and income drawdown products are excluded.
>
> Because the approach is non-standard some of the prospective purchasers would like to see some more explicit confirmation that GAD feels the approach is reasonable."

Comment on this explanation has been made in the earlier discussion of the topic.

89. GAD replied on 23 November 2000. They suggested that the way the matter had been phrased in the returns had been confusing:

> "At first sight this seems to be an additional allowance for renewal expenses, but it now appears to be a Zillmer adjustment in respect of unrecouped acquisition costs."

They asked for further specific justifications about its use.

Scrutiny Report on the 1999 Returns

90. On 24 November GAD submitted its scrutiny report on the 1999 returns. The returns had been submitted in June 2000, before the House of Lords' verdict and to that extent were by then of doubtful relevance. In 1999 the Society had experienced an improved year on the market with an overall investment return of 16% (including an income yield of 3.9%). The Society had announced a total growth rate of 12% (an increase from 10% declared in 1998) which comprised of 3½% GIR (again at 0% for new policies), 1½% reversionary bonus and 7% terminal bonus). This placed the balance as between reversionary and terminal bonus at 18/82, a further shift in the bonus mix.

91. Part of the cost of the bonuses was met by a call on capital appreciation of £490m. The residual unallocated return went some way to reducing the excess of aggregate with profits policy values over assets to 103% (105% in 1998). The accrued final bonus figure now stood at over £6 billion. The interest rate used in the liability valuation remained at 3¾% as against a gross bonus rate assumed of 2%. The regulatory cover factor had increased to 3.47x (from to 2.5x in 1998) and included credit for an implicit item of £925m and for the subordinated loan of £346m. Without these the cover would have been 2.33x. In addition the Society were permitted to set off £1.1 billion in reinsurance of GAR-related contracts against the total liability for these in the returns (as agreed at the time the returns were submitted). Without these three adjustments the cover would have been reduced to 1.34x. The return included a gross GAR provision of over £1.6 billion. The reinsurance treaty deduction resulted in the provision for a net liability of £565m. This contrasted with a provision of £200m within the accounts and the Society's commercial cost estimate of £50m. Reversing the quasi-zillmer adjustment would have caused a further significant reduction in the position.

92. The scrutiny report ran to 28 pages and headlined the Society's priority rating as 2, the same as for 1998 report[10]. The format of the report was now more reflective of the risk-based approach to regulation that FSA had initiated in anticipation of 'N2', the date on which the new Financial Services & Markets Act would come into force. The scrutiny process had proceeded in the customary, retrospective, way in parallel with the dramatic changes in the Society's position, but inevitably contained material that related to current events. On its returns, the Society had a cover for RMM of 3.46x. No action points had been identified, but GAD had written to the Society on 23 November, asking for justification for the assumed 85% take-up rate for the annuity guarantees, and how this accorded with the new guidance letter (issued in December 1999). GAD also asked about the basis of the assessment of the liability for future GAR contract premiums, some questions about the valuation basis and the resilience tests, and how the Society justified the ½% quasi-zillmer adjustment in the resilience scenario.

93. In the executive summary, the scrutiny report commented on the *Hyman* case and the House of Lords' decision; the need to stop writing new business if the sale process failed; and the risks to which the Society was subject. These risks included the low cover for RMM without the reinsurance, implicit items and subordinated loan (1.36x); the lack of an estate; the wide range of ages over which benefits could be taken; doubts over the quasi-zillmer adjustment in the resilience tests; the risk of higher reserves required under new regulations; the unsatisfactory reliance of the renegotiated reassurance treaty upon regulatory arbitrage to achieve the desired result that would not assist in the event of insolvency; failure to follow the December 1999 guidance on valuing GAR reserves; exposure to falls in the equity market; inability independently to reinstate the 7 months' bonuses forgone during the year; PRE issues; and liability to enforcement action relating to mis-selling of income drawdown products. Apart from issues relating to the sale, the risks now identified

[10] See chapter 15 for an explanation of the priority ratings. Under the service level agreement between HMT, FSA and GAD a priority rating of 1 was generally reserved for company had failed to maintain its RMM or apparent weakness in the valuation basis suggested that the RMM might not be covered.

had entered into the Society's approach to managing its business progressively throughout the 1990s.

94. The usual tables of premium income over five years were set out. The difficulties with the income drawdown product were described. The new business index showed a year on year decrease of 15% for 1999. There were no notifiable changes in the business in force. Expenses were reported as usual, including the customary note that the Society's expenses ratios were the lowest in the industry, being only about half those of their nearest competitor. There was analysis of assets and investment performance. In relation to the valuation bases, there was the now customary reference to the Society's gross premium valuation and the approach to calculating the resilience reserve so that the total liability was identical with the results of the net premium valuation. There were concerns about the reserving basis, as already mentioned, and about the dependence on equities as backing for reserves, given the flexibility of the age range at which benefits could be taken. It was noted that, at the 3 November meeting, the Society had intimated that they did not believe that the new regulations would lead to any material increase, but confirmation of this had been sought.

95. In relation to options and guarantees, the report set out the reserving assumptions used in the 1998 return and Headdon's justification thereof. There was comment on the take-up rate assumed (85%). The impact of the House of Lords' judgment on the first reassurance treaty was noted, together with reference to the renegotiated treaty that provided for protection where there was more than a 60% take-up. The off-sets arising from the treaty were tabulated. It was noted that about one quarter of the annuity guarantee reserves related to benefits to be bought by future premiums. The appointed actuary appeared to have assumed that the premiums would reduce by 20% per annum, and that was thought imprudent. The appointed actuary had also told GAD that on the worst-case scenario the annuity guarantee reserve for future premiums would double. Questions had therefore been asked about this part of the reserve. It was noted that the cost of the proposed rectification scheme could be up to £200m.

96. The report commented that, at first sight, the solvency position looked reasonable, but when the implicit items, future profits and reinsurance offset were disregarded the cover was just 1.36x – "a less than satisfactory picture for this large fund". The Society had confirmed that the aggregate asset shares were close to the value of the fund. It would be unable to meet RMM if the FTSE-100 Index fell 15% from the end of August levels. The Society had acknowledged that it had little alternative but to arrange a sale and demutualisation if new business was to continue. Discussion of bonus policy and PRE followed the pattern of the previous year, with additional points referring to immediate events: "Unfortunately for Equitable", the House of Lords had ruled conclusively against their differential terminal bonus policy, and accumulating with profits pensions policyholders had foregone 7 months of bonus this year, the reinstatement of which was largely dependent on a successful sale. There was nothing noteworthy in the remainder of the report.

97. GAD had little alternative but to carry through the scrutiny process and to report: however the context had changed between the year-end and the completion of the scrutiny. The new emphasis of the report (ie the risk-based approach) was much more informative than previous scrutinies. In addition it highlighted (for all practical purposes for the first time) the precarious position of new joiners (touched upon by Hewitson in his note following 3 November meeting). However these improvements in regulatory practice had come rather too late for the Society and its policyholders.

98. In the few days that followed the issue of the scrutiny report further consideration was being given to the Society's options. On 28 November Hewitson entered the discussion, repeating his earlier call for an independent report if no sale was achieved. His note listed a number of ways in which the company's "realistic

financial position" could be improved. One option was to "[r]emove GAR on future premiums, saving say £250m reserves". Hewitson has told the inquiry:

> "It was my idea to consider a statutory limitation of premiums for GAR policyholders. However the lawyers said you could not do that, as it would be interfering with the contractual rights of the policyholders."

Preliminary advice to that effect came from the general counsel's division on the 8 December (the day the Society was to close to new business), although Roberts seems to have been aware of such advice as early as 5 December. In an email to Foot and other colleagues he notes that:

> "Initial (but firm) legal advice is that our intervention powers do not allow us to interfere in contracts (and the right to top up is a contractual one)."

99. On 29 November Headdon responded to the scrutiny letter of 23 November. His letter set out detailed comments on a wide range of factors relating to the valuation. He sought to justify his approach to reserving for the annuity guarantees, criticising the guidance as failing to express any higher requirement. He asserted that appropriate provision had been made for future premiums on GAR policies. He emphasised aspects of his valuation that were particularly prudent. He sought to justify the quasi-zillmer adjustment.

100. By this stage most of the points dealt with were of interest to a purchaser of the Society, and comment was focused on that interest. Headdon appears to have been anxious to deal with the scrutiny as business as usual, but to have had an eye to criticisms that were emerging from the due diligence processes associated with the sale.

101. Hewitson commented to the inquiry about the exchange with Headdon on the ½% adjustment:

> "[In his 16 November letter to me] he set out his technical rationalisation of why this treatment was reasonable... At a technical level I understood what Chris Headdon was saying logically, and I accepted it as a plausible treatment for an ongoing fund, but I could not reconcile it with the legal requirements that he seemed to be interpreting differently. He could just about rationalise his stance technically. In [the GAD response of 23 November] we were not expressing a view or showing ourselves as undecided but were gathering information at this time to enable us to take a view. For example, I wondered if he intended to put forward an argument there was a margin of more than ½% between the expected yield on existing assets and his discount rate for the liabilities, which could have been a possible technical rationale. However he did not come back to us with any such argument, or evidence to support such an argument. Chris Headdon's reply of 29 November 2000 says '*Clearly if a substantial proportion of policyholders surrendered a failure to reflect un-recouped initial expenses in the basis used could have a material detrimental effect on the remaining policyholders*'. This point comes back to the administration account or realistic position of Equitable from which appropriate surrender values would be determined, and is not about regulatory return figures."

On 30 November Hewitson proposed that GAD should reply to Headdon's explanation on this point by saying that GAD had difficulty in understanding his approach, which seemed contrary to the regulations and would not be acceptable in the 2000 returns. The comfort sought by Headdon for the bidders on this point was clearly not going to be forthcoming from GAD.

102. Meanwhile, on 29 November Allen wrote to Nash describing the bidding process as "hotting up" and requesting a meeting to discuss a number of particular issues on which the bidders had sought FSA's views, which he listed as:

> "1. The application of Article 4 of the Equitable's articles;

2. Reserving issues;

3. Interim arrangements between announcement of a preferred bidder and approval of a schedule 2C scheme;

4. State of play on compliance issues."

At a meeting which had taken place with one of the bidders that day the bidder had indicated that "comfort on reserving issues would be critical to the bid, as would the legality and presentational issues surrounding the interim arrangements".

103. The suggested meeting with the Society was scheduled for 1 December. On that morning GAD e-mailed FSA with their position in advance of the meeting. GAD had by now clearly considered the Ernst & Young reports. The e-mail made gloomy reading:

- GAD wanted to see an increase in the assumed take-up rate from 85 to 90%;
- GAD were unhappy with 20% per annum decrease assumed for future premiums. If this were not assumed the net liabilities would increase by up to £360m;
- The amended regulations could require the Society to assume that personal pensions benefits would be taken at 50, which could (according to the Ernst & Young report) mean an additional £200m;
- The new resilience test would lead to increased reserves of between £300-£600m;
- More sophisticated hypothecation of assets could reduce the resilience reserve by up to £750m;
- GAD did not accept the use of the ½% adjustment in the resilience scenario. The resilience reserve was therefore weak and not in accordance with the guidance[11]. The e-mail noted:

  "Ernst & Young say that reserves are £950m lower than they otherwise would have been because of this."

GAD summarised the effect of these points as:

> "Total effect minus £1,010m. Excess assets fall from £1,080m to £70m. In other words we estimate that the Society are currently very close to not covering their RMM. If the GAO reassurance treaty were terminated, liabilities would increase by about a further £1000m."

104. Roberts has told the inquiry:

> "During the latter part of 2000, William Hewitson was in close contact with the business and I knew that he was becoming more pessimistic about the position... There had been a difference of opinion between William Hewitson and Chris Headdon on the margin by which Equitable was covering its RMM. The difference amounted to about £1bn, with Chris Headdon's estimate being the higher...
>
> The Ernst and Young report is something we would have liked to have seen sooner. It addressed points that had not been part of the previous debate

[11] In their maxwellisation response, the Treasury have observed that the gross impact of £950m in the resilience test was off-set by a re-hypothecation of assets to liabilities, which improved the position by £750m, leaving a £200m net effect. I do not dispute that, but it does not address the point that the quasi-zillmer adjustment was an unsanctioned practice that had been used to improve the position up to that point. The fact that another adjustment could be found to reduce this impact is irrelevant. The inquiry has not had the material necessary to consider whether the benefit claimed from the rehypothecation was justified, and in my view there is reason to think that the Society's non-reliance on hypothecation up to this point reflected deliberate policy to increase flexibility in setting bonus rates.

between Headdon and Hewitson. Headdon could have reported these points earlier, particularly in relation to the half percent Zillmer adjustment. It is possible that Headdon misunderstood the regulations in this respect.

> Equitable were not always as open as they could have been. However I had no evidence they were actively misleading us. William Hewitson never said that he thought he was being misled or lied to. I put his disagreement with Equitable down to an actuarial argument in relation to actuarial assumptions.
>
> Given the very active debate between GAD and Equitable, I was confident that we had a good idea of the financial position of Equitable. During the sale period, the financial position was not such as to warrant intervention action. In any case our efforts were largely directed to monitoring and facilitating the sale process.
>
> In the event, the fact that no sale took place was a close run thing; there were still two bidders in the running several months after they had the information in the Ernst and Young report. The report's contents cannot be said to demonstrate that the company would not sell. I do not believe that earlier sight of the report would have led us to act differently. I do not think that knowledge, or additional resources at GAD during this period, would have altered the decisions we made or the eventual outcome."

This assessment of the level of understanding of Equitable's financial position, and of the prospects for sale that the regulators had at the time does not strike me as particularly realistic. They did not have the information they needed to form a realistic view of the prospects of sale. However, I have no reason to contest the belief that earlier sight of the Ernst & Young report would not have led to different action on the part of the regulators.

105. The minutes of the 1 December meeting recorded that by now there was only one realistic potential bidder remaining. The matters raised in the GAD e-mail were raised, but not resolved. The Society confirmed that the ½% adjustment had been in place "since the early 1990s". GAD stated that it was their understanding that Ranson had agreed not to make use of it. Commenting on the 'revelation' to the FSA of the quasi-zillmer adjustment, Allen told the inquiry:

> "At this point, the fitness of Headdon was in our minds, but no formal action was taken whilst he was Appointed Actuary; there was a suggestion, which was not pursued, that the Government Actuary should have a word. When Headdon became managing director, we did consider this formally and advice was sought from General Counsel's Division; but in the event, the Halifax sale went though and the issue fell away because he was moved to a different position."

106. The issue about policyholders joining the fund after the House of Lords was raised at this meeting. The minutes recorded:

> "The Society did not appear to be unduly concerned about WP policyholders who joined after the House of Lords' judgement... The Society had not considered whether [they] could be excessively disadvantaged in a closed fund. This is because after this date the preferential treatment of GAR policyholders was known. Going forward if GAR policyholders had a greater propensity to top up their benefits than previously this will be to the detriment of non GAR policyholders. John Young[12] thought that it might in these circumstances be possible for these policyholders to get a preferential bonus treatment."

It is certainly the case that the Society took no steps to consider or make provision for the protection of late joiners. They were more concerned to deny 'carpetbaggers' the benefits from a successful sale. Hewitson has made the following comments to the inquiry about the issue of those who joined the fund after the House of Lords:

[12] A solicitor from Lovells advising the Board.

> "Mis-selling to 'new' policyholders was picked up as a topic after the Warren opinion [May 2001] and the FSA also took their own counsel's opinion. Quite a number of earlier non-GAR policyholders might also have been disadvantaged. Really this was a conduct of business issue concerning the disclosure of risks to incoming policyholders... Largely it was in my view a legal issue as to whether Equitable could set up a separate fund for new policyholders, because of the difficulties from the House of Lords' decision, which forbade the ring fencing of GAR policies, and the constraints set by its own articles of association which do not seem to envisage complete segregation of funds. Equitable looked at this using its own legal advice. In addition, there would have been technical problems over the utilisation of existing 'capital' to support a new fund. GAD was not asked to advise on any of this at the time."

Allen commented on the same subject:

> "There was a balance to be struck about new policyholders at that time [after the House of Lords' judgment] who might end up joining a fund that would close. We looked at the risks to new policyholders, but it was clear to us that there were overwhelming benefits in keeping Equitable open and their going for the sale. What was going on with Equitable was in the public domain and in terms of new business, there were methods for dealing with any mis-selling."

On the balance to be struck, Allen told us:

> "The most important issue for the regulator was whether we should close The Equitable to new business at this point [after the House of Lords' judgment]. This would have been an extremely contentious move. One has to understand that regulation involves a delicate balancing exercise as the regulator's actions could damage the majority of policyholders' interests rather than protect them. In this case, the regulator was faced with a company that was still solvent, had experienced a problem which we thought they could survive and which had decided to raise capital by a sale. Given that background, it was questionable whether the regulator in fact had any grounds upon which it could intervene... The benefit [of closing to new business] would have been that late joiners... would not have joined; but they may be able to bring a claim for misselling if they had entered into the agreement on a false premise. Our judgement was that the balance of interests between existing policyholders and new joiners lay clearly in favour of allowing Equitable to remain open to new business."

Whatever the correct conclusion about whether a separate fund was in fact possible, the available documents do not reveal any consideration of this possibility by FSA or GAD in the aftermath of the House of Lords' judgment. Allen has told the inquiry that the issue of compensation was not the only, or even the main justification for the decision not to close, which I entirely accept. But the conclusion that late joiners would be able to bring a claim for mis-selling still begs the questions of how they would individually establish grounds for compensation, and, if they were successful, of who would meet the cost of any compensation ordered as a result. As the *Hyman* litigation should have demonstrated by now, the outcome of any legal proceedings involved risk: the material complaint that the Society and the regulators have to face is related to exposing the late-joiners to risk, without considering the alternatives that might have been open.

107. On 4 December FSA were notified that one of the two potential bidders had now formally withdrawn. On the same day the other potential bidder reported to FSA that, whilst they were still making progress in addressing some of their concerns, "they were becoming increasingly concerned about the 'economics' of any possible deal". Having taken this call, Roberts was mindful of the risk that they might in fact withdraw and recognised that the FSA would have to be ready to explain why they had not closed the company immediately after the House of Lords' judgment.

108. On the same day GAD formally responded to the points raised in Headdon's 29 November letter along the lines proposed (and described above).

109. On 5 December Allen briefed Foot for his upcoming meeting with the Society. He outlined the reality of the cumulative figure from the GAD e-mail of 1 December and concluded:

> "On this basis, it is very difficult to see how the Equitable could justify continuing as a going concern in the absence of a bid. We believe we would have grounds for closing the company to new business under the Act (either for failing to meet its required minimum margin of solvency, or because of the risk that PRE would not be met). But we would prefer that the Equitable's directors took this decision for themselves."

Meanwhile Roberts was considering the fall-out from any decision to close to new business, and in response to an e-mail from Foot, he remarked:

> "On other companies, I agree that we should major on the distinguishing features of the Equitable. In fact the combination of a deliberate avoidance of building up an inherited estate and the fact of being a mutual with consequent problems in raising capital does make the Equitable's case pretty much unique (we may get some incidental and much needed recognition that inherited estates are not all bad)."

The 'uniqueness' of the Society was something of which the regulators had been aware for many years. While it appears to have formed part of their explanation for its downfall, it does not appear to have particularly informed their approach to its regulation.

110. The meeting with the Society took place on 6 December, by which time the Society appears to have been informally told that the final potential bidder was unlikely to make an offer. Although there was some discussion about keeping certain funds open (the Society having made the decision to close the with-profits fund), Sclater agreed that they would close to all new business if no bid was forthcoming. On 8 December 2000 the Society announced that it was closed to new business.

Closure to New Business

111. In my view, there can be no criticism of the management in taking prompt action to close the Society to new business immediately after the withdrawal of the last potential bidder. Nor can regulators be criticised for supporting that decision. It was the alternative to the sale process, supported by Schroders, that was identified as soon as the contingency of failure in sale was identified. Having taken the view that the best interests of policyholders and potential policyholders were, on balance, best served by keeping the Society open to new business, there can have been little option but to close when, and only when, the potential bidders had signalled their withdrawal and the prospects of a successful sale had disappeared.

112. Nor, subject to the specific criticism mentioned below, do I criticise the Society for wishing to continue to carry on business, as near to usual as possible, after the House of Lords' decision, nor FSA for the decision to permit the Society to continue to sell new business. The Society wished to realise the best price possible for the Society, and that objective was best served by maintaining its functional capacity. When considering whether the Society should close, the regulators were faced with competing interests. It is a legitimate and necessary part of prudential regulation that the interests of existing and potential policyholders may need to be balanced. It is clear from the documentary and witness evidence that the essential conflict of interest was recognised. The view that the value of the Society as an ongoing business was such as to justify keeping it open, while the option of a sale was supported by the views not just of the management and the regulators but also the professional advisers engaged by the Society.

113. Should a similar issue arise in the future, the general question would remain the same, and a similar balancing exercise would be required. The exercise of judgment in such circumstances does not readily benefit from hindsight. Had the sale process succeeded in realising a substantial value for goodwill, all would have benefited to a greater or lesser extent. So long as the prospect remained real, in the minds of those engaged in the process, persisting with the process was a reasonable approach.

114. It has been suggested to this inquiry that the decision not to close to new business demonstrates that it is wrong to have prudential and conduct of business regulation under one roof. I strongly reject that argument. Indeed, I think that the Equitable Life experience argues strongly that the two forms of regulation need to be better integrated than they had been prior to the closure of the Society. But the view that there is a conflict is anyway based on a misapprehension as to the sort of decision that had to be taken. This was not a case of competition: prudential versus conduct of business regulation, with one representing one discrete set of interests, and the other another. The balancing of the interests of existing policyholders against those of potential policyholders is intrinsic to prudential regulation. The various Acts that preceded the current legislation all recognised prudential responsibility to <u>potential</u> depositors, investors, policyholders or members. The need to consider this balance is perhaps most clearly illustrated by reference to the banking sector, where FSA (and previously the Bank of England) had responsibilities towards both depositors and potential depositors under the 1979 and 1987 Banking Acts, even though deposit-taking was not subject to conduct of business regulation. Whenever there is cause to consider the closure of a business that invests the public's funds, there will need to be some consideration of, and balancing between, the interests of both existing and potential investors. That would be the case regardless of regulatory structure.

115. However, there is an aspect of the decision to permit the Society to remain open to new business that does cause me concern. It appears that the regulators proceeded on an assumption that, if anyone were disadvantaged by the decision, compensation would be available. No legal assurance was sought that this would be so, and there was no examination of the legal issues involved. There was no recognition recorded that, if compensation claims were sustained, those claims would be at the expense of the with-profits fund, nor any attempt to quantify the risks to which potential policyholders were exposed relative to the benefit claimed by management for continuing to trade. No consideration was given to measures that might have mitigated the potential for subsequent claims of misrepresentation. The Society was even permitted to continue its advertising, and so those taking new or further policies with the Society did so by invitation and not as mere volunteers, without the risks of doing so being made known to them.

116. Neither FSA nor GAD had sufficient independent knowledge and understanding of the Society's business to justify the confidence that a sale could be achieved, and this should have been reflected in the care with which this decision was taken, and options to mitigate the impact of failure on new contributions were explored. Whether an acceptable scheme to protect late members or continuing members in respect of late contributions could have been developed by the Society is unclear. The option of opening a new policy class to protect late contributions was not practicable in the circumstances. Article 57 of the Society's articles of association stipulated for a special resolution of the Society for exercise of the power in sub-clause F of the memorandum of association to create a special fund or special funds, or to give to any class of policyholder or annuitant any special right over or interest in any fund or funds so created. Notwithstanding the range of contracts written, and the distinctions drawn in bonus distribution practice over the years, Equitable had never had resort to that provision, and its effect was untried. But there might have been contractual options open in the case of new contracts at least that would have allowed for penalty-free transfer of funds to another provider, for example, in the event of failure of the sale: that could have been seen as an

appropriate counterpart of the proposal to exclude such policyholders from the benefit of the proceeds of sale. Other possibilities could no doubt have been developed. To allow business to continue without exploring means of protecting those who were exposed to risk by the decision, and relying on an untested view that there would be a remedy was unfortunate.

Headdon's Proposed Appointment as Managing Director

117. Immediately following the closure to new business, Nash resigned. On 20 December 2000, Headdon was proposed as the new managing director (it was already intended to appoint a new appointed actuary). Under the 1982 Act, FSA had to decide whether to approve this appointment, object to it on the grounds that Headdon was not fit and proper to be appointed to the post, or simply to allow it to take effect by not raising objections within a prescribed period.

118. FSA were presented with a dilemma. Headdon had been closely involved with the management and policy decisions that had led to the current situation, particularly on annuity guarantees. On the other hand, his handling of the fall-out from closure was considered by FSA to have been competent, and the value of ensuring some continuity was recognised. Allen advised Foot on 26 January that "it would certainly not be in the interest of policyholders to move him from his post [as acting managing director] at this stage".

119. Allen discussed the possibilities of persuading the Society to withdraw the application and leave Headdon as acting MD, or seeking to impose a time limit on the appointment. The problem with the first option was adverse publicity that would inevitably follow and further undermine confidence. The time-limited option was difficult to justify, as had been found with Ranson. Allen therefore came down in favour, although clearly reluctantly, of a policy of non-objection, justified on the grounds that the Society was effectively in run-off, which reduced the significance of the post, and that any buyer would wish to decide on senior officers.

120. On 2 February it was noted within the general counsel's division that the grounds for objection did not look strong. The position was resolved without a decision having to be taken when FSA were told on 20 February that Headdon had been offered an alternative position within Halifax, so that a new chief executive would need to be appointed in any case. Confirmation from Headdon the following week that he was indeed moving to Halifax was accompanied by the question of whether FSA would be content for Thomson to combine the roles of chief executive and appointed actuary. FSA duly discouraged this, and the authority's views were accepted.

Postscript: the July 2001 policy value reduction

121. I have already outlined some of the key events following the closure to new business in chapter 5 [crisis & closure, 1997-2001]. Regulatory concern in the immediate aftermath clearly focussed on finding a solution that would stabilise the with-profits fund and secure the best interests of policyholders. As I have already said, it is not for me to evaluate the deal with Halifax plc that resulted. The factors that FSA would be taking into account in considering any proposal were clearly set out and communicated to the Society and its advisers. As I have commented already, these factors reflected a growing realism about the true scale of the Society's financial difficulties. No purpose would be served in dealing in detail with these issues. Other issues, such as the subsequent revelation of the side letter to the reinsurance treaty, have been mentioned at appropriate places elsewhere in the report.

122. However, I wish to comment briefly on the events surrounding the July 2001 policy cuts, which immediately preceded the launch of this inquiry. As should be clear from chapter 6 [lifting the veil], this decision was indicative of the true financial position of the Society.

123. Following the submission of an application for a future profits implicit item of £1.1 billion for 2001 on 28 June 2001, on 29 June the Society requested an emergency meeting with the regulators to follow up a letter Thomson had sent Roberts the previous day. Thomson was accompanied by the financial director, Charles Bellringer, and by the appointed actuary, Peter Nowell. In the letter Thomson acknowledged that policy values exceeded available assets by 10%, and at the meeting he revealed that the current terminal bonus rates were no longer considered sustainable. According to the FSA note of the meeting, he explained that this stemmed in part from the small proportion of the Society's business that was annual premium, which meant that in run-off the long term fund went rapidly into decline. The flexibility of the contracts exacerbated the problem as it allowed policyholders to withdraw funds "during a wide window of opportunity". The appointed actuary had advised that the Society needed a return for 2% for the year to "keep their heads above water", while the current return was negative.

124. The Board had discussed the issues on 27 June and was meeting again on 2 July to consider the options. It had been thought that a cut in interim rates from 1 August would be enough, but it was now recognised that "more drastic steps would be needed". Thomson outlined the options:

> "One option being considered would be to remove some of the transparency from the process by which terminal bonus is added to pension plans from year to year. Effectively the proposition was that they would cease to show the rate of accrual of the non-guaranteed terminal bonus. This would be consistent with the practice for much of the industry and some other types of Equitable Life policy, but it was a clear step back into opacity which would not go down well. It could be seen as a mechanism for frustrating the GAR. The alternative would be to deliver a cut to policy values by some means to bring them more closely back into line with the underlying assets. This could be done by reducing the amount of accrued terminal bonus, or by making a reduction in the overall policy value, but so as not to take the value below the guaranteed value in any individual case. Either approach would be difficult, and in order to sell this course of action they thought that they would have to be explicit that they would look to restore the bonuses if and when financial markets improve. Charles Thomson confirmed that if there were a significant rebalancing of policy values, they would expect to reduce the financial adjuster on non-contractual terminations, perhaps to 5%."

It was agreed that this would require some disclosure in the 2000 returns which were now due.

125. At the meeting there was discussion of the Board's decision to cease to allow top-ups to GAR policies for those who had not maintained premiums, in reliance of a hitherto unenforced contract term. According to Ford, it was revealed at the meeting that the Board had not obtained "comprehensive legal advice" that this step was valid. In response to FSA concerns, The Society agreed not to implement the decision until FSA had had a chance to consider the issues (they were subsequently advised by counsel that four weeks' notice was required).

126. FSA met Thomson and Bellringer again on 4 July. The Board had resolved to reduce total policy values, rather than reducing final bonus, despite the practical difficulties there were with this course. However, he had subsequently met with counsel, who had questioned whether in the absence of a reserve to meet possible compensation costs, the Society could be confident of paying out any sums in excess of guaranteed benefits. In light of this he was considering a more radical approach, the suspension of all final bonus and a complete freeze on surrenders until the position was clearer. However, Thomson recognised serious drawbacks with the approach, including an implicit recognition of greater mis-selling claims, and he would keep both options open until the Board could be convened later that month.

127. The Board met on 13 July and decided to announce on the following Monday that pension policy values would be reduced by 16%, that the interim bonus for the

first six months of 2001 was being reduced from 8% to zero, and that the interim bonus for the remainder of the year was to be reduced to 6%. At the same time the MVA would be reduced from 15% to 7½%.

128. At an internal meeting on 18 July, FSA subsequently decided to require, among other things, that the Society freeze payments of terminal bonus, shift further funds from equities into gilts, and apply the MVA to terminal, but not guaranteed bonus. They also decided to issue a notice under section 44 of the 1982 Act, requiring the Society to provide monthly financial information and to demonstrate its solvency. (At the same meeting it was noted that a court would probably include PRE in calculating policy values for the purposes of the Policyholders Protection Act.)

129. The following day Allen met Nowell and told him about the increased requirement for regular financial information, and outlined additional steps that had apparently been discussed between Davies, the FSA chairman and Vanni Treves, the president of the Society. In a departure from traditional DTI/HMT practice, FSA were proposing to appoint a firm to undertake an independent financial review, along the lines of the reporting accountant system used for many years for banks. This was a clear marker from FSA of an intention to move to a more intrusive form of regulation for the Society, and appears to have provoked a considerable reaction from the new Board and its professional advisers.

130. There was a further meeting between FSA, led by John Tiner, and Thomson and Bellringer. Among issues discussed, the position on top-ups was clarified. Allen asked Thomson for his reaction to press comment to the effect that policy values had exceeded fund value for an excessive period. Thomson replied that, in his view, policy values were too high as at end 1999, and that they "could have been corrected by a 1% reduction in at least some years during the 1990s". For a normal fund, even this divergence need not have been a problem, but the Society had an unusually high proportion of policies approaching maturity.

131. The change in the actuarial leadership of the Society had brought fresh thinking to bear on its overall financial position. Equity markets were falling, and there was an appreciation that the Society's bonus system was resulting in the haemorrhaging of assets from the with-profits fund as a result of over-payments of policy proceeds. The failure of the first sale process, and the limited success of the second, still conditional at this stage so far as the major element of the disposals was concerned, left the Society seriously exposed. At the reference date the GAR liabilities had not been resolved. The Society was in a parlous position, the result of developments over many years, which regulation had failed to uncover.

PART VII: CONCLUSIONS AND LESSONS

CHAPTER 19: CONCLUSIONS

1. In this chapter I will outline briefly the events recounted in this report relating to the Society and its actions, before discussing the roles of the Board, executives and auditors of the Society, and then the regulatory regime and how it was applied in the case of the Society. I will deal with some of the more significant representations I have received as I do so. At the end I will highlight some of the central conclusions and turn to the lessons that might be drawn for the future.

2. As throughout this report, I have not qualified my comments by reference to professional standards current at the time events occurred: that is a matter for the courts and professional bodies exercising disciplinary functions. Further, I have the benefit of hindsight, and I have not restricted the comments made to those matters that can be shown to have been within the knowledge or contemplation of individuals or groups at material times. In seeking material from which lessons can be learnt for the future it would be impossible to restrict oneself to what individuals knew or ought to have known at any time in the past. The lack of knowledge may itself be an important source of material pointing to lessons for the future.

The Society

3. Until the early 1970s the Equitable Life was a relatively small, conservative life office servicing a narrow market. The bulk of its business was generated by the FSSU, an endowment-based pension scheme for university teachers that required little in the way of marketing and management, and was of its nature aimed at an intelligent and articulate clientele. This appears to have insulated the Society from general competitive pressures.

4. However, from the mid-1960s the Society faced the prospect of the loss of FSSU business as proposals to update the tax treatment of pension schemes generally began to be discussed[1]. The necessary legislation was passed in 1970 and from 1975 new university business declined rapidly. The end of the FSSU presented the Society with a dilemma: it had to find a new market and adopt a more active marketing stance to develop business to substitute for FSSU, or face decline as it serviced a diminishing book.

5. The Society elected to embark on active marketing, and adopted a series of strategies aimed at increasing market penetration. The Board decided to target the upper end of the market, with which the Society had some familiarity. Increasingly sophisticated marketing strategies were developed in the late 1960s and early 1970s. The Society developed its own dedicated sales force and branch network. The executive developed new products designed to be attractive to that market. And they developed a range of distinctive features that could be said to distinguish it from the competition.

6. Three distinctive features are of note. First, the Society marketed on the basis of high levels of service provided to policyholders, both in terms of the highly flexible products on offer, and in terms of ancillary financial and tax advice provided. Second, there was a consistent emphasis on low expenses, in absolute terms and by comparison with the industry, and the absence of commission paid to third parties. There are issues about whether the advertised ratios in the 1990s were over-influenced by the Society's practice of treating policy switches before and at maturity as claims and new business simultaneously, and whether the deliberate reliance on direct sales may have insulated the Society to some extent from direct comparison at

[1] See chapter 3 and Appendix C.

the point of sale. But the Society seems to have been generally successful in sustaining a low expenses policy. Third, and central to the Society's projected image, was the emphasis on mutuality and the two benefits the Society proclaimed as inherent to its mutual constitution: no shareholders to take a share of returns, and the members' ownership of the business.

7. A corollary of the absence of shareholders as competitors for the Society's assets and profits was the absence of a source of external finance in case of need. The Society made a virtue of this by developing and advertising the theory that the with-profits fund was the source of working capital for the development of the business, and was remunerated for the capital risk it undertook by the allocation of part of the resulting profit to policyholders on maturity. In this way current generation policyholders supported new-generation policyholders, but were rewarded in due course from the profits generated by the new business. The mechanism by which the reward was returned was not explicit, and the theory of capitalisation for growth from policyholders' contributions was controversial.

8. The members' ownership of the business was also significant to the manner in which the Society was run. It was expressed in and after the late 1980s in the total allocation policy: current surplus was not held back for later generations of policyholders. Policyholders were encouraged to take the view that the Society's practice was to allocate all available surpluses as they arose, subject to a degree of smoothing, in contrast to other offices that withheld benefits that should have been available from current surpluses. This approach, and the absence of a free estate, was presented as being a continuation of an approach that dated back to the establishment of the Society in the 18th Century, although this was part of a mythology that was build up over the period covered by this inquiry. In fact the Society's reserves, in off-balance sheet capital appreciation and hidden margins in liabilities, amounted to over 40% of its long-term liabilities at the end of 1972, and following the adverse market conditions of the mid-1970s, the Society briefly set about building up reserves of free assets again until the early 1980s.

Origin of the Annuity Guarantees

9. In Maurice Ogborn, the Society had until 1972 an actuary in the historic mould, highly regarded and innovative. As second in command to Henry Tappenden, and then as 'the Actuary', who under the Society's constitution was the chief executive, Ogborn was responsible for developing a contract form with a range of core features that readily lent themselves to adaptation to changing market demands.

10. In 1956-57 Ogborn developed the Society's original with-profits retirement annuity form of contract on the basis of a pre-existing recurring single premium endowment policy[2]. However, it did not initially form a major part of the business. At the quinquennial valuation of the fund at 31 December 1961, the main classes of business were whole-life and endowment assurances. The retirement annuity policy (RAP) did not begin to make a significant impact until the next decade.

11. The design of the product was to become important with the growth of business. The RAP was designed to fit in with the use of a common rate of return to policyholders across the with-profits fund along with other business and in particular endowment business. Endowment business at the time was sold on premium bases that allowed for an implicit guaranteed investment return (GIR), with the premiums loaded for profit in addition. Those characteristics were incorporated into the new RAP.

12. The Society's FSSU contracts had provided that the endowment fund built up to maturity could be applied to purchase a pension in annuity form. The Government effectively underwrote the pension element to ensure that the recipient obtained on retirement a minimum pension related to length of service. In addition

[2] See chapter 2.

to these particular features, related to wider fiscal policy, the Society offered FSSU contract forms that provided a guaranteed annuity option at maturity. For this additional benefit the Society charged an additional premium.

13. In developing the RAP form Ogborn introduced some specific features that came to characterise pensions business until 1988:

i. Conversion rates were guaranteed in the contract for the whole duration to maturity in every case. (It is this conversion rate that has generally been identified as the guaranteed annuity rate or GAR[3].) The cost of this benefit was known from FSSU experience.

ii. The policyholder was free to make contributions on pre-determined terms of a value greater than any contractual minimum, subject only to Inland Revenue limits.

iii. There was flexibility in the selection of pension age.

iv. There were contractual options available to the policyholder, but the primary obligation of the Society was to pay the specified annuity.

Despite subsequent claims to the contrary, there is persuasive evidence that the cost of the annuity guarantee was incorporated into the RAP premium bases[4].

14. The annuity guarantees reflected in the annuity scale incorporated into the contract were initially based on a low rate of investment return, of 2½%, later increasing to 3%. In October 1975 the rate was increased to 3½%. The implicit interest rate component in the conversion rate in possession, originally 4%, was increased in October 1975 to 7%.

15. The increases in the investment rate and the conversion rate reflected the generally upward trend in interest rates until the mid-1970s. In the 1980s, however, when market rates began to fall, the Society did not revise the investment rate or the conversion interest rate implicit in the contractual guarantees in response.

16. Until the mid-1970s, the Board supplemented the guaranteed annuity to a level related to current immediate annuity rates, reflecting the inherently conservative levels of guarantee implicit in the contract. There was, before 1973, no terminal bonus policy in place, and the device of a discretionary final annuity bonus or adjustment enabled the Society to overcome one of the limitations inherent in a fixed guarantee: that it depressed returns in good market conditions. That policy of supplementing the annuity rate was superseded a few years later, when terminal bonus had become part of the Society's normal bonus structure and was seen to provide the flexibility the Actuary wanted to adjust total returns.

17. As fiscal legislation developed, the Society provided a commutation option, and later an open market option in existing and in new contracts. The commutation option, which was introduced in 1971, required the Society to break down the annuity guarantee into two stages, each reflecting two of the underlying actuarial assumptions that had implicitly characterised the original design of the contract by Ogborn, and the distribution policies that had been developed around them:

i. Commutation rates were adjusted to ensure that the benefit of the final bonus adjustment designed to uplift the guaranteed annuity to current annuity rates was not available in cash form;

ii. The net conversion rate in possession could then be used to express the appropriate part of the annuity as a cash sum;

iii. The elements of the total guarantee reflected in the conversion rate on commutation were the implicit interest rate, 4% or 7% according to generation, and the mortality assumption applied at inception;

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[3] See foreword for discussion of this terminology.

[4] See chapter 2, paragraphs 16 to 23.

iv. It became possible for financially sophisticated observers to identify the net effect of the implicit expenses deduction and the investment roll-up rate applied in computing the guarantees.

18. The process of development was carried further when the open market option was introduced in 1978. Policy forms were altered to make explicit in separate tables the accumulation of premiums net of expenses at the implicit investment roll-up rate, and the conversion rate in possession reflecting the implicit interest and mortality assumptions applied in the computation of the annuity guarantee.

19. The flexibility of the Equitable RAP was one of its most significant features. By the end of 1975, the Society sold a retirement annuity contract that:

i. Incorporated a premium guarantee, subject only to Inland Revenue limits, for the whole duration of the contract;

ii. Guaranteed conversion rates for the whole duration to maturity in every case;

iii. Allowed flexibility in the selection of pension age; and

iv. Granted specified options to take alternative benefits while underscoring the Society's primary obligation to pay the specified annuity.

The premium guarantee, which allowed further contributions to be made on the same terms, and the flexibility over when benefit matured were to prove particularly significant to the Society as it sought to deal with the outcome of the *Hyman* case.

Origin of the Differential Terminal Bonus Policy

20. As the era of the retirement annuity contract was about to expire with the advent of personal pensions in 1988, Equitable decided to remove guaranteed conversion rates in possession from its new pensions business. The Society offered only a fixed expenses deduction and a guaranteed investment return from 1 July 1988 on personal pensions business and individual personal pensions. The Society also sought to remove the annuity guarantees from group pension scheme and AVC business from 1988, but faced opposition from trustees who insisted on five years' notice under the terms of the scheme contracts. However, the Society continued to operate retirement annuity and the individual pension plan business written before 1 July 1988 without attempting to withdraw or modify the implicit conversion rate guarantee, accepting additional contributions on that basis throughout the reference period.

21. Crucially the Society did not open a new bonus class that might have distinguished the pensions business sold before and after 1 July 1988 according to their respective benefits provisions, but, for marketing reasons, presented the new business as effectively a continuation of the old.

22. When the Society took that course, there had been a decision, reached by executive management in about 1983, that, if market interest rates should fall below the level required to support the guarantee for a sustained period, terminal bonus practice would be adapted to reduce the cost of the guarantee to the Society[5]. If that had not been the intention, the decision to market the new policy forms as effectively a continuation of the old, despite the different rights attaching to the different generations of policy within the same fund, would have misrepresented the interests of the respective cohorts of policyholders affected.

23. As finally manifested in the differential terminal bonus policy, this decision to recover the costs of the annuity guarantees in the event of sustained low interest rates from terminal bonus was to be the subject of the *Hyman* litigation in 1998-2000. The inquiry has found no evidence that the policy was disclosed to the Board until December 1993, a decade after it appears that it was formed and five years

[5] See chapter 2, paragraph 51 et seq.

after the introduction of personal pensions, and this raises questions about the Board's decision to maintain a single bonus series that are considered below.

24. The policy was not disclosed to policyholders by direct communication, in any way, until 1996, in the bonus notices for the 1995 declaration. Earlier references in the Society's regulatory returns would not have disclosed the policy except to some experts reviewing the returns in detail. Failure to disclose this intention must be regarded as a serious omission in communication to policyholders of relevant information about their prospective interests from at least 1988, and arguably from the time in the early 1980s that management first took that decision.

Greater Technical Efficiency

25. Meanwhile, the Society's pensions business continued to be marketed using contract forms that were closely related in substance to, though materially changed in form from, the original RAP. The Society continued to introduce innovative changes to policy forms, and to develop new lines of business on the basic underlying model within the with-profits fund.

26. In 1987 the Society introduced the with-profits annuity, the first of a new generation of policy forms that were designed to widen the range of business, and to reduce liability reserving requirements over time. This very popular form allowed the annuitant in possession to participate in the with-profits fund. Subject to the ordinary risks associated with that fund, the with-profits annuity implicitly assumed the escalation of annuity benefits over time, but with an increasing proportion of the annuitant's interest reflected in non-guaranteed bonuses. Although it generated high initial technical reserves, the with-profits annuity became 'technically efficient' in that it reduced progressively the 'guaranteed' element of total benefits and reduced reserving requirements.

27. Another form, a with-profits bond, proved successful, but was withdrawn in 1997 because it was not 'technically efficient'. The Society also introduced forms of income draw-down policies in the early to mid-1990s with progressively reducing guarantees designed to increase their 'technical efficiency'.

28. Although these developments, and other parallel product developments, were intended to withdraw policy guarantees progressively, the Society continued to base its products on the fundamental ideas of premium flexibility, flexibility as to maturity date, and the availability of recurrent single premium terms.

29. Overall the Society developed an impressive range of products that appealed to the relatively sophisticated market sector that it targeted. The changes in the underlying assumptions within the developing forms of business would not, however, have been apparent except to financial analysts familiar with actuarial methods.

Distribution Policy

30. As noted already, the need to attract new business in the late 1960s and 1970s produced a new emphasis on competitive position. When the drive to replace the FSSU business got underway, declared bonus rates were the index of competitive performance, and the measurement of distributable surplus was the key to declaration.

31. Up to the end of 1972 the distribution policy followed by the Society provided for, and resulted in, a strong balance sheet with, as noted above, the accumulation of substantial reserves of free assets. That was, in part, the result of the tardiness of the Board in adjusting to an environment in which there had been increasing investment in equities, and, in the market conditions of the time, increasing capital appreciation. In part also it reflected a general conservatism in distribution policy that focused attention on revenue yields, and regarded capital appreciation as inherently unstable and unreliable as a basis for distribution. The Board had only reluctantly decided that up to 10% of available capital appreciation could be appropriate to supplement revenue for bonus purposes.

32. Board policy recognised the need to see that each generation of policyholders was equitably treated while maintaining the necessary, ample, reserves to provide full security for the Society's obligations. Contrary to later claims by the Society, it was explicit policy that each generation of policyholders entered the fund with the benefit of a heritage from the past and had to pass on a like heritage to its successors. The published policy position in the early 1960s was an eloquent statement of the desirability of an inherited estate, later to be rejected as repugnant to the principles applied by the Board.

33. With the departure of Ogborn in 1972, the successor team of Barry Sherlock and Roy Ranson took the initiative in developing a new, rational, approach to the appropriation of unrealised capital appreciation: the 'three-call' system[6]. In the light of current expectations, this system was inherently prudent, providing for:

i. Support of declared bonus from capital appreciation up to the benchmark rate of the redemption yield to maturity on gilts;

ii. Reserves sufficient to support future reversionary bonus over the period when equity yields were expected to remain below the gilt yield reference level; and

iii. Distribution of any surplus capital appreciation to supplement bonus as the Board thought appropriate, and in particular by terminal bonus.

Thus, under this new methodology revenue returns were topped up by appropriating capital appreciation, first to support current declared reversionary bonuses, secondly to ensure that funds were available to support future reversionary bonuses, and thirdly, so far as there remained a balance of capital appreciation, to provide a new bonus element, the terminal bonus.

34. This third element, the 'third call', was inherently volatile, reflecting current property and equity market conditions. The policy adopted envisaged that smoothing of the volatility of the third call could on occasion involve allocating terminal bonus beyond immediately available capital appreciation. But that would be in a context in which the second call provided ample reserves for future reversionary bonus, and more generally a cushion against later adverse experience.

35. When the new policy framework was first disclosed to the Board, markets continued at the high level established at the end of 1972; ample surplus was anticipated at the end of the triennium; and interim and terminal rates forward were adopted on optimistic assumptions. However, in 1973 equity markets began to fall. The collapse continued into 1974. All financial institutions were affected. The Board's dilemma was clear. A conservative approach would have required lower bonuses in response to falling markets. Interim and terminal bonus rates would have had to be cut. The Society's competitive position would have been undermined at a critical point in the development of new markets for the Society's products. The view was taken that it would have been disastrous to cut bonus rates.

36. The Society maintained its bonus rates and drained its resources. The capital appreciation available at the end of 1972 was applied or lost in 1973 and 1974. The 1974 internal valuation was adjusted to take maximum advantage of the reduction in market value of the assets and the resultant increase in nominal revenue yields in valuing liabilities. By reducing liability valuations, a surplus was generated and interim bonus rates were maintained. There had been no effective recovery when the triennium ended in 1976.

37. From 1977 until 1982 the Society struggled to recover its free assets position. The three-call system was elided by an *ad hoc* bonus policy that sought to maintain declared rates while strengthening the liabilities, restoring hidden margins and increasing the investment reserves. By 1982, when assets had to be disclosed on the

[6] See chapter 3, paragraph 14.

balance sheet at market value for the first time, the Society's accumulated reserves, representing capital appreciation, had recovered and were at a high level.

38. However, from the early 1980s the Board's bonus policy became increasingly driven by the pursuit of growth in new business. It was understood that the Society was falling behind in competitive terms, and in particular that its terminal bonus levels were not matching those of its principal competitors. A highly competitive market dictated the level of bonus allocation. The surplus published by the Society became a function of the desired level of bonus.

39. With the restoration of a position of relative strength in 1982, the three-call system came under review. Ranson, then appointed actuary, began to advise on on-going policy in terms that challenged the need for and desirability of the second call. Over the next three years, the second call was first reduced and then abandoned. Having instituted a rational approach to bonus distribution in 1973, which involved prudent reserving for future reversionary bonus and related terminal bonus to sums standing at the credit of the investment reserve, the Society abandoned the theoretical three-call system without it ever having been fully implemented in practice.

40. Over the 1980s the Society maintained competitive levels of bonus allocation by cutting back on its general reserves until, by 1987 it had over-allocated bonus so that its aggregate policy values on a realistic basis exceeded available assets. Ranson and actuarial colleagues in the Society published in *With Profits Without Mystery*[7] a robust defence of the Society's policies and approach, putting the actuarial profession on public notice of the policies it intended to pursue. The mixed response included polite expressions of disagreement and disquiet.

41. 1990 was a disastrous year for the industry. Equitable suffered a serious loss of value on its equity holdings. The Society's response was pragmatic. It reverted to the practice of 1974 and, despite what was objectively a loss of capital value, generated an apparent surplus for allocation by maximising the interest to market value ratio used in valuing liabilities (see below). The Society also reduced declared bonus relative to total allocations, so that the proportion of the total allocation that was reflected in its liabilities valuation fell progressively. The trend in that direction had begun in the 1980s and continued throughout the 1990s.

42. Declared bonus rates were maintained broadly on a par with or slightly below general industry levels. Final bonus rates were competitive. In and after 1988 league tables were prepared on the basis of actual pay-outs at specified durations for typical products. The Society targeted the pensions position at sensitive levels, typically 15-year durations, and sought to maintain competitive position by adjusting its terminal bonus tables to produce appropriate results. In and after 1989 the Society adopted a new approach to accumulating policy values forward that automatically benefited longer durations and produced good comparative results for those durations.

43. The Society succeeded in producing good comparative returns throughout the 1990s, and presented an attractive competitive position to the market. It was successful in winning substantial new business as a result until 1998. Thereafter adverse publicity surrounding the annuity guarantee issue began to affect its competitive position.

44. The generation of surplus was critical to the Society's marketing position and success. Surplus was generated in ordinary course by investment returns achieved on premiums and contributions received, by non-profit business, by surrender terms, in particular when, from time to time, the Society operated a market value adjustment, and by actuarial techniques that reflected the Society's pragmatic approach to generating surplus required to support levels of bonus desired to maintain market position.

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[7] See chapter 4.

45. Thus the Society maintained a bonus record that enabled it to achieve consistent growth in new business premium income, net assets, and fund values over the greater part of the inquiry's reference period. It repeatedly advertised these factors as the indices of success. Whatever the other attractive features of management on which the Society relied in projecting its image, growth could not have been achieved without the support of a bonus allocation and distribution policy that produced high policy values and high policy proceeds.

Terminal bonus

46. The generation of surplus for allocation depended to a material extent on the approach to recognising accrued terminal bonus. With the exception of a specific provision of £6m in 1979, the Society never made provision in its statutory accounts, or its regulatory returns, for accrued terminal bonus. There was no obligation to set up mathematical reserves or technical provisions for accrued terminal bonus[8].

47. Until about 1986 the investment reserve was roughly equivalent to the accrued aggregate terminal bonus. The averaging system used to adjust the 'crude' terminal bonus rate (the ratio of the investment reserve to the long-term fund) to a 'smoothed' terminal bonus rate could result in excess allocations when the reference period reflected falling returns. But the relationship was maintained in broad terms, and the investment reserve was generally equated with the terminal bonus pool.

48. In 1986 and 1987 general reserves were called on to supplement the investment reserve for terminal bonus purposes. By the end of 1987 aggregate policy values exceeded available assets at market value. For 1988 returns and bonus allocation were roughly in balance. In 1989 the allocation of terminal bonus accounted for a large proportion of the available surplus. There was a significant residual surplus and the excess of aggregate policy values over available assets was reduced. In 1990 the aggregate policy values intimated to policyholders were significantly higher than the assets available as a result of the allocations of that year. Thereafter the with-profits assets of the Society were never in excess of or equal to aggregate with-profits policy values including accrued terminal bonus[9].

49. The Society followed the general view that terminal bonus was not guaranteed and did not have to be provided for in mathematical reserves or technical provisions. Unlike other offices, it adopted an extreme view that funds did not have to be held in any form to cover any material part of future payments of terminal bonus. In the case of the Society distributable surplus was computed without reference to terminal bonus other than that paid during the period ended with the date of the valuation. The Board was informed that terminal bonus was technically efficient because one did not have regard to what was allocated, only to what was paid. By disregarding accrued terminal bonus, the Society was able to over-allocate bonus beyond its available assets at market value, and in particular to make payments on claims that exceeded the relative available assets at the time.

Liability Valuation and Financial Adjustments

50. The inquiry has identified a number of aspects of the liability valuation and financial measures designed to support the Society's solvency position, and its ability to continue to allocate bonus at competitive levels[10].

51. Between 1990 and 1996 the Society valued its annuity liabilities in its published financial statements on a basis that differentiated its future bonus rate from the valuation interest rate, using an interest rate higher than the bonus rate. The higher rate was used in its net premium valuation for regulatory purposes. The result was to reduce the liability valuation and inflate surplus. This was not consistent with best actuarial practice and was inconsistent with the Society's own

[8] See chapter 10.
[9] See chapter 6.
[10] See chapter 7.

established practice. The practice generated surplus available for allocation by mathematical means that were inconsistent with an intuitive view of the Society's ability to pay. The allocations, over the period affected, were reflected in policy values, and in particular in claims values, throughout the 1990s.

52. From early in the 1990s the Society applied a quasi-zillmer adjustment for the procuration expenses of recurrent single premium business that eventually had an aggregate value of about £1 billion. The methodology employed was not explicit in the early 1990s, but latterly the adjustment was made in the regulatory resilience calculations where it served to reduce resilience reserves, and was therefore reflected in the surplus available for distribution. This was not consistent with sound and prudent actuarial practice. The practice generated surplus that was not properly available for distribution.

53. The Society also lagged behind generally accepted thought in adopting updated mortality factors in valuing its annuity business, deferred and in possession, thereby increasing the surplus available for allocation, by reducing the long-terms liabilities of the Society.

54. The Society included in its assets for office purposes 'aspirational' assets in the form of the new business loan, expenditure on computer systems etc, that were not realisable and should have been disregarded on a prudent basis.

55. The Society also took a number of measures to bolster its solvency position for regulatory purposes and help mask a deteriorating realistic position:

- i. issuing subordinated debt;
- ii. making extensive use of implicit profits adjustments; and
- iii. entering into a financial reinsurance agreement which supported regulatory solvency without material transfer of risk.

Each of these practices raises particular issues and these are discussed further in the context of the regulation of the Society.

Financial Weakness of the Society

56. Cumulatively these factors contributed to a position of significant over-allocation of bonus that culminated in a weak liability position that was a major contributory factor to the weakness that required a substantial reduction in policy values in July 2001[11]. By 1987 at the latest, accrued terminal bonus exceeded available investment reserves. Over a period of years, beginning not later than 1987, rates of both reversionary and terminal bonus were set at levels that inflated maturity and other claims values to levels that were not sustainable without continuing high returns on investments, and in particular continuing capital appreciation, with the aggregate excess cost at maturity or on other claims being continually (and increasingly) passed on to succeeding generations of policyholders. That was the case notwithstanding that rates of reversionary bonus did decrease over time.

57. The excess of allocations over distributions throughout the 1990s was known to management, and was recorded in data produced regularly and circulated among executive management to inform decisions, and in particular as an aid to calculating and applying market value adjustments. More detailed analysis by the inquiry showed that the over-allocation was attributable substantially to past claims, and had crystallised accordingly. The changes in policy terms, and other technical adjustments in the 1990s were an attempt to reduce reserving requirements in respect of new business beyond the changes achieved by shifting the bonus mix progressively from guaranteed to un-guaranteed benefits. In 1997 Chris Headdon, then appointed actuary and co-author of *With Profits Without Mystery*, thought that it would take fifteen years (from an unspecified starting point) to bring allocations

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[11] See chapters 6 to 8.

into equilibrium with assets by withholding part of current surplus from allocation to policyholders.

58. The excess of policy values over assets increased until, at 31 December 2000, the un-funded portion of aggregate policy values was about £3 billion, of which £1.8 billion had crystallised and had been lost to the fund through claims. The decision in *Hyman*, and the additional liability of £1.5 billion on top of that erosion of fund value through over-allocation and over-payment made future independence impossible. The attempted sale was inevitable thereafter. The position further deteriorated during 2001, with continuing over-payment and falling equity values.

59. A key feature of the Society's bonus system, introduced in 1989, was the uniform smoothed investment return allocated to accumulated policy values. While the actual split between the guaranteed return, reversionary and terminal bonus might vary between policy structures, the same total return was allocated to policies regardless of duration. This was in contrast to the approach of other companies, which operated a more flexible bonus system where terminal bonus could be varied according to policies' duration in-force. Common practice allowed for inter-generational smoothing and so avoided locking in payout patterns. By effectively giving up this flexibility, the Society significantly reduced its ability to smooth payouts and thereby manage the aggregate of such payouts within available resources.

60. The consequence of the Society's approach to bonus, combined with sustained over-allocation, was a complex pattern of differentials between policy values and asset shares that depended on policy duration. There was no effective means by which the Society could correct the overall differential, which was progressively crystallised into a pattern of payout ratios, without a drastic revision of the policy values already intimated to policyholders. Such action was not considered until the second quarter of 2001. The Society sought to claw back past over-allocations from in-force business in 2001, but until July of that year the basic pattern of payout ratios in excess of 100% of asset share continued.

61. While it was still possible, using the Society's bonus system, to bring aggregate payouts in line with asset shares, this would have involved paying some policies less than their asset share. It is evident that for contractual claims the Society paid out on policy value, the payout ratio being in excess of 100% of asset share for the period from at least 1989 to July 2001. While it did apply varying financial adjusters to non-contractual claims from time to time, such application was discretionary, and crude, which reduced the effectiveness of the mechanism to claw back value. While the Society made attempts to smooth in-force business, it did not do so on claims generally, thereby in effect crystallising a fund deficit of an estimated £1.8 billion by 31 December 2000. Given this situation, it would appear that not only did the Society fail to manage appropriately and address inter-generational transfers, but it greatly encumbered new and in-force business.

62. Various representations have sought to suggest that the pattern of policy values observed by the inquiry was consistent with the Society's smoothing policy. Apart from the absence of a consistently expressed and coherently followed smoothing policy (of which more below), it is hard to reconcile what the inquiry has found with any credible approach to smoothing. Smoothing is generally taken to imply that payout ratios should average 100% of a projected norm over time, with aggregate policy values and payouts running below the level of available assets during market peaks, and above the level during downturns. A rigorous and prudent adherence to a clearly defined set of smoothing parameters would appear to be all the more essential in a fund that is being operated on the basis of a policy of full distribution and no estate. The Society's pattern of 'smoothing across the peaks' (to borrow Headdon's phrase) did not represent, and could not have represented, a credible approach to smoothing for a mutual espousing the principles the Society did.

63. As a result of the practices adopted in the generation of surplus for allocation, in the allocation of total bonuses, and in the excess payout on claims, the Society was 'overdrawn' on the internal office valuation to the extent of £4.4 billion by about mid-July 2001. The cut in policy values in July 2001 reflected in part the loss of investment value in the stock market collapse in that and the preceding year, and in part the cumulative effect of over-allocation, and in particular the resulting over-payment on maturities and other claims from 1987 onwards.

Table 19.1: Office valuation position from 31 December 2000 to 31 August 2001

With-profits fund	**31/12/00**	**30/06/01**	**31/07/01**	**31/08/01**
	£m	£m	£m	£m
Net assets	**25,843**	**22,848**	**22,500**	**21,965**
With-profits liabilities at full value	21,467	19,670	19,303	18,893
Guaranteed annuity provision	1,500	1,500	1,257	1,257
Face value of guarantees	**22,967**	**21,170**	**20,560**	**20,150**
Accrued terminal bonus	5,933	6,055	1,340	1,330
Aggregate Policy Values	**28,900**	**27,225**	**21,900**	**21,480**
(Unfunded) Funded Policy Value Position	(3,057)	(4,377)	600	485
Aggregate policy values as a % of net assets	**112%**	**119%**	**97%**	**98%**

64. The year-end relationship between aggregate policy values and underlying assets (net assets), as depicted by the Society's own records, reflected a ratio of 105% in 1989 and thereafter peaking at 128% and 120% in 1990 and 1994 respectively. From these peaks the Society was able to smooth down the position on in-force business, to 102% in 1993 and 103% in 1999. The position thereafter deteriorated again in 2000 to 112%, as shown in the table above, which was largely attributable to market performance and the need to accrue for the annuity guarantees. Due to a combination of continued poor market performance and excess payouts, the position further deteriorated to 119% before policy values were cut in July 2001, bringing aggregate policy values and underlying assets more into line and for the first time during this period below 100%. However, despite the Society's apparent attempts to correct the imbalance, particularly after 1997, it is important to note that the ratio never fell below 100% prior to the 2001 adjustment. The fundamental impact of this was that claims continued to be paid out well in excess of asset share, thereby exacerbating the Society's financial weakness and placing a greater strain on new and in-force business.

65. In addition to the broad valuation issues that arose as part of the background to the July reduction, principally accrued final bonus, mortality, the GAR issue, and aspirational assets, there were unresolved issues relating to policyholders' and former policyholders' claims for damages, the status of the subordinated loan, the appropriateness of future profits implicit items adjustments, the financial reassurance of the GAR liabilities, and the identification of on-going contractual guarantees.

Representations on the Inquiry's Financial Analysis

66. I note that I have received various representations concerning the inquiry's analysis of the financial position of the Society. Ranson in particular has contested my comments in this regard. However, the basis of my views is set out in chapter 6 and reflects the actuarial and accounting advice I have received. Ranson has also commented that I have ignored the intra-year position, that Ernst & Young's report for the sale process identified significant accrued profits in in-force business beyond

those taken into account, and that I have ignored embedded value and goodwill. I have not taken account of these factors, but consider it immaterial. A consistent pattern has emerged at year-end over a long period of time, and in any event, Ranson's general comment about intra-year positions without specification of any relevant difference is unhelpful and without material significance. On the basis of Ernst & Young's report the Society would have been saleable, but it was not sold. Embedded value and goodwill were not realisable while the Society was a going concern mutual running a mixed business.

67. I have also received representations on behalf of some non-executives to the effect that they do not recognise my analysis of the financial position, that on the advice they received and on external assessments the Society was subject to no financial dangers or risks that were not taken into account until the *Hyman* decision, that they did understand that terminal bonus crystallised on claims, and that had they known of a position as I have described, they would have queried it. They say that they understood that bonus levels had been set at prudent levels in the light of the Society's smoothing position and the general economic climate. These observations do not alter these findings. Discussion of the developing position is set out in chapter 6, and I discuss smoothing further below, and since the non-executives in question did not attend for interview, what it is said on their behalf that they understood is not material to which I can attach significance.

68. Nor are the findings altered by the objections from Thomas and Bowley, two of the executive directors, that it is difficult to see how over-distribution could occur in the Society's case, given the policy of full and fair distribution, given that the returns achieved on the invested assets were generally comparable with their competitors, and given the limited number of top rankings achieved by the Society. The reasoning behind these representations is surprising, given the individuals' background and experience, but not such as to disturb the conclusion set out.

69. As for the claim frequently made by the Society, and cited in a number of representations, that it had a policy of smoothing bonus distribution, there was no adequate statement of that smoothing policy or its parameters, in terms of cycle or maximum deviation from any norm, against which decisions on distribution might have been reviewed. It has been represented to me that the Board was given regular indications of where the Society was at any time in the smoothing cycle. I have referred in the report to the particular instances I have identified, including the one on 15 November 1995 commented on by solicitors in their representations on maxwellisation. The specific instances do not persuade me that there was at any time an adequate statement of the smoothing policy. If their clients have other information it has not been disclosed to me.

Policyholders' Reasonable Expectations

70. There are two aspects of PRE[12] that have to be considered, relation to the annuity guarantees, and in relation to final bonus. The first is more limited, but is more conveniently dealt with first.

71. The Society's publications and communications with policyholders until 1996 (in relation to the 1995 distribution) gave rise to the reasonable expectation that total policy proceeds at maturity, or other point of claim (subject to MVA at certain times), made up of the accumulation of premiums, GIR, reversionary bonuses and a final bonus, would be computed irrespective of the form in which annuity benefits were claimed. This was seen early in the historical treatment of RAPs, in the provisions of the contract, and in the explicit provision in the commutation tables for the reversal of the final annuity bonus or adjustment when the cash commutation option was exercised. That provision was required only because it was assumed that otherwise the fund equivalent of the annuity would include the

[12] For a discussion of the origin and interpretation of PRE, see chapter 13. Chapter 14 considers PRE in terms of the Society's own practices and communications with its policyholders.

addition. Illustrations, bonus notices, and correspondence all pointed in the same direction until 1995.

72. Attempts were made to change expectations in 1996 and later years. These were ill-conceived, poorly expressed, and confusing. The intimations to policyholders were generally uncommunicative. They did not fit with the contractual provisions to which they were intended to relate. They could not seriously be considered as instructing new expectations, even if that were theoretically possible. (There is an issue whether an office can alter PREs retrospectively: if the PREs have been established, prima facie unilateral assertion of a different and inconsistent position is a breach which, if material, would require regulatory intervention.)

73. In 1998 and 1999 the attempt to amend expectations was continued. There was inadequate communication of the Board's intentions even then. However, whatever the resolution of the position in the final two years, it was fundamentally inconsistent with established PREs for the Society to attempt to implement the differential final bonus policy in respect of contributions paid up to and including the publication of the bonus notice in 1999 for the 1998 declaration. The Society should have reserved for annuity guarantees in full up to and including 1997, even if beyond that date there was scope for change.

74. There is a separate issue whether PREs were generated in respect of new contributions on pre-July 1988 (i.e. GAR) policies after the Society's position was made clear in public in 1998. No policyholder making a contribution after August 1998 could have been in doubt about the Society's position in the Hyman litigation. Additional contributions in that period could not have been made in the expectation that the differential terminal bonus policy would not be applied if the Society were entitled to act in accordance with its stated policy.

PRE and Final Bonus

75. On the more general question relating to final bonus, the Society's position on PRE was that, because accrued terminal bonus was not guaranteed, it was payable wholly at the discretion of the Society, and did not require to be reserved for or recognised in any other way prior to payment. In and after 1989, when the Society adopted a new approach to accumulating policy values, the failure to recognise accruing final bonus in its entirety was untenable, having regard to the terms of the statute and to the Society's publications and communications with policyholders.

76. On no view of the meaning of the expression 'policyholders' reasonable expectations' could it properly be asserted that it related exclusively to guaranteed benefits. The expressions 'contractual', 'guaranteed' and 'consolidated' were used as synonyms by the Society and must be construed in that sense in the bonus literature distributed to members.

77. Policyholders would have known at all times that the amount of accrued terminal bonus intimated in bonus notices was not due as a matter of contractual right. But that did not and could not close the issue. Having regard to the origins of the expression, and the circumstances of its incorporation into the legislation, PRE had a wide compass and, in particular, covered future non-contractual financial benefits. Protecting policyholders' interests in future bonuses (as then understood) was a central feature of discussions of PRE in the early 1970s.

78. Subject to the terms of the communications, policyholders presented with the Society's policy value statements from 1989 had a reasonable expectation that a final bonus would be incorporated into the policy proceeds at maturity, subject to the conditions of the market at the time. Indeed policyholders (and the Society's Board and the profession through *With Profits Without Mystery*) were told in the 1990s that the bonus mix was irrelevant: only the final proceeds mattered to them. That representation was consistent only with a *bona fide* intention to pay a final bonus according to current market conditions and the stage in the Society's current smoothing cycle, if there were a relevant smoothing policy. The sole qualification in the documents was that the level of final bonus was dependent on market

conditions at the contractual date of claim. The level of expectations ought to have been conditioned by expectations about the performance of equity and property markets in particular.

79. The Society predicted future reversionary bonus as an element in the calculation of surplus on its preferred actuarial methodology. The Board could not have asserted that there was no expectation of continuing surplus. The claim for a future profits item had implicit in it the assertion that current values of in force business implied valuation margins that allowed for the emergence of future profits. The quasi-zillmer adjustment, subordinated loan and financial reassurance each required the availability of future profits. The continued investment of new money in equities and properties would have been imprudent without the expectation of future growth in yield and market value.

80. The failure to cover future terminal bonus by the retention of funds, given the expectations generated by representations, and by the Society's sustained practice of paying such bonuses on maturities and other claims, contributed significantly to its ultimate weakness.

81. These general factors provide the background to an assessment of the impact of the *Hyman* decision, and the need to make provision for annuity guarantee liabilities. The necessary provision was, in absolute terms, a material sum. But its impact would have been less if the Society's capital base had not already been eroded by over-allocation and in particular by over-payment on claims. On previous experience the shock would have been sustainable.

82. The Society was under-funded to the extent of £4½ billion in the summer of 2001. It had contributed to that position by over-allocation of bonus, reflected in over-payment on claims. Surplus had been generated by an extreme use of actuarial techniques, and applied to support bonuses of all kinds. The question arises as to who knew and how the decisions were taken.

The Board

83. The composition of the Board changed over the period I have investigated. Some directors have died. Some have been and remain infirm. Some have agreed to interview, and have co-operated to a greater or lesser extent, largely depending on whether they have been involved in litigation brought against them by the Society. Some have refused to be interviewed. Some have asked that their identities and terms of office be disclosed in the report. Some have asked that their membership of the Board should not be disclosed. As more fully set out in the foreword, I have taken the view that I should deal with the Board as a continuing unit. Since it is not my task to adjudicate on individual responsibility for events that have taken place, and since I have relied on hindsight rather than attempt to distinguish what was known at any given time from what emerged subsequently, that has appeared to me to be the most appropriate course. I note that some directors have criticised this approach, which one executive has described as "curious" and "inherently unfair", but I remain persuaded that it is the only one that could be adopted by the inquiry in the circumstances.

84. Formally under the articles of association the Board resolved on bonus levels on a report from 'the actuary', who was in effect the managing director under the articles. The Board received extensive reports from the actuary on the Society's financial position, and on the levels of bonus they might allocate and declare. However, on balance it appears to me that the Board was never fully advised of the financial implications of the decisions that were said to be open to them, and, in particular, of the impact of claims on the resources covering with-profits business.

85. The executive over most of the reference period provided financial information in series of reports that did not bring together all relevant information at any one time, such as would have been provided in what came to be called an annual

financial condition report. In particular, a comprehensive report, however designated, would have presented an assessment of future scenarios that put in issue the resilience of the Society in adverse financial circumstances. As a result of practice, the Board had fragmented information and, even if directors had all the relevant pieces of the jigsaw, they were most unlikely to have been able to piece them together and form a picture of the totality.

86. While the Board established committees to study in detail matters such as investment, remuneration, and nominations, at no time until 1994 did it establish any committee that could have had within its remit the monitoring of product risk, or liability valuation and the risks associated with that exercise and the associated exercise of bonus allocation and distribution[13]. In 1994 an audit committee was set up. Of its nature an audit committee could have captured the area of liability valuation. It did not do so until initiatives late in 1997 began to have effect in 1998, by which time the Society's problems were largely beyond resolution.

87. Internal management committees dealing with risk assessment concentrated on areas that left product and liability risks substantially untouched. They dealt with systems monitoring, internal controls, fraud by staff, accounting systems, and similar topics. There is no doubt that the Society's management systems were well-developed, and benefited from the attention of the review units. But the level of attention given to these matters serves to underline the absence of any equivalent body to scrutinise the actuarial functions of the Society (which were located at Aylesbury, away from the head office).

88. There was no effective monitoring of risks associated with product design and development. Development involved considerable imaginative effort that was centred in the product investigation team (PIT). But no one 'audited' the PIT, and there was no effective control of the reserving requirements generated by new policy forms outside of the actuarial team. So far as the Board was concerned, control over policy drafting and development was delegated to the actuary with occasional reference to the president. Generally, the Board was less than well-informed of the Society's realistic financial position, and by its resolutions on bonus brought the Society to the position of weakness in which it found itself in 2000 and 2001 without full knowledge and understanding of the developing position.

Role of the Non-Executives

89. None of the non-executive members of the Board had relevant skills or experience of actuarial principles or methodologies over most of the reference period. They were generally experienced in the financial services industry, but specialists, where they had specialist knowledge, in general finance, in investment and banking rather than life assurance. They could not be expected to make independent judgements without specific guidance from the actuaries on and advising the Board. There were executive directors with relevant actuarial qualifications, but little or no relevant experience, and they were in any event inhibited by the terms of professional guidance (which prohibited qualified actuaries who were directors from doing anything to undermine the authority of the appointed actuary).

90. I accept the evidence of those non-executives who were prepared to be interviewed by the inquiry that they did not know of the extent of over-allocation as brought out in the office valuation of liabilities. If that is so, they did not understand the risks to which the Society was exposed. I can express no view on the position of those who declined to attend for interview. The reasons for the relevant directors' lack of knowledge were that the non-executive directors were:

i. Ill equipped to manage a life office by training or experience;

ii. Totally dependent on actuarial advice;

[13] See chapter 9.

iii. Ill-prepared to take necessary decisions in any event because of the fragmented approach adopted to instructing them; and

iv. Incompetent to assess the advice objectively and challenge the actuaries even if they had questions about the material supplied.

91. The non-executive directors generally had a poor understanding of the Society's developing financial position. They had delegated actuarial management to the professionals. Delegation is, in principle, necessary in the management of any complex commercial organisation. In an extreme case, total abrogation of all responsibility for actuarial management of a life office could not be. Whether the directors from time to time did what was required for proper performance of their duties is not for me to say. I have not sought to test their performance against any body of evidence of what others in their position would have done in the circumstances, or otherwise collected evidence or sought to adjudicate on allegations of breach of duty that others have made or might have made. An inquisitorial process could not attempt to supersede the ordinary courts in the exercise of their jurisdiction. My function has been to look at what happened, and how it contributed or may have contributed to the position at the reference date, and to draw any lessons for the future.

92. In the course of maxwellisation representations, non-executive directors and their legal representatives have repeatedly stated that criticisms that relate to matters of an actuarial nature that were not known, and could not be known on the information supplied, to a generalist non-executive director, or otherwise could not reasonably have caused them to ascertain or pursue the concerns identified, set standards that are unrealistic and would be impossible to achieve for an individual without actuarial experience[14]. It should be clear that I have not sought to set standards of conduct for any past period. I do have an interest in using what happened as the basis of comment about the future. But it has to be said that there is and will continue to be a material difference between the ability to carry out work, and in particular the technical calculations, that an actuary is qualified to perform and understanding the results of that work.

93. In the same representations it has been repeatedly stated that criticism of non-executive directors related to failure to oversee the actuarial functions of the Society are misconceived, because they were entitled to rely and did rely on the actuaries on the Board and the actuarial team. And, it is said, they relied on the auditors, regulators and in particular GAD. At no time, it is said, did the auditors or regulators alert the Board to the kinds of comments made by me. It has been said that it is little short of absurd to expect a generalist non-executive director, without experience in actuarial issues, to have ascertained the matters that form the basis of my comments when external experts failed to do so.

94. Whether or not reliance on external safeguards was appropriate in contemporary circumstances over the period I have investigated is not a matter for me to comment on. Again, however, if the position should be as represented to me, it has significance for the future governance of life offices. Whether or not the representations reflect views common in the industry, one would wish to ensure that the future conduct of life business reflected acceptance by non-executive and other directors of personal responsibility for the direction of the actuarial functions of the office. The long-term liabilities of life offices do tend to dominate one half of the balance sheet. If it were indeed absurd to expect an understanding of the actuarial issues that arise in their valuation by 'generalist non-executive directors', that is a matter of some importance for the exercise by regulatory authorities of their function of approval of nominees for appointment to life offices' boards.

[14] The comments reflect specifically the observations of Allen & Overy with which most of those non-executives who have made representations expressly agreed. Many of the representations commented on in this section were made by Allen & Overy, but I have not sought to attribute them in every case.

Bonus Allocation

95. Against the background of these general comments, I turn to specific issues. It is appropriate to comment in the first place on bonus policy. In terms of the Society's articles of association, formal responsibility for distribution lay with the Board at all times. Having adopted a rational approach to bonus distribution policy in 1973 that involved prudent reserving for future reversionary bonuses and related terminal bonus to sums standing at credit of investment reserve, the Board as constituted over the material period began progressively to reduce the reserves held for future reversionary bonuses from 1983 until that aspect of the previous reserving policy was abandoned entirely in 1985. In and after 1983 the amount allotted as terminal, later final, bonus was progressively increased. (It has been represented that if such policies existed they were never made known to members of the Board over the last few years before the *Hyman* litigation. I have no information on the extent of the information given to new directors in the course of induction. But the issue is material to the FSA's proposals for published PPFMs and other statements of practice discussed in the next chapter.)

96. The Board was advised repeatedly, and acted on the basis of the advice, that future terminal bonus could be withdrawn instantly and did not require to be provided for or otherwise recognised in order to run the business in a prudent and sustainable manner. Insufficient attention was paid to the aggregate policy value position of the Society (figures for which were routinely calculated as part of the Society's systems) as compared with the aggregate market value of the assets.

97. This statement has been challenged on behalf of certain of the non-executive directors on the grounds firstly that GAD expressed a view on 16 January 1998 that showed no concern about the excess of policy values over available assets, and secondly that correspondence dated 3 and 8 November 1995 between Headdon and Ernst & Young supported the Society's approach to full distribution. However, these specific events do not disturb the basis of views formed by the examination of board papers and minutes over a long period of time. Bowley and Thomas have commented that the pattern of allocation was a natural consequence of movement in the securities market over time. I refer the reader to the detailed discussion of the development of these policies in Part II to this report. The same individuals have commented that the criticism implicit in the observations fails to acknowledge actual experience within the fund. I have dealt with the realities in chapter 6. I have found no basis for altering the comments above on the basis of their representations.

Excess of Policy Values over Assets

98. As noted above, accrued terminal bonus exceeded available investment reserves by 1987 at the latest. Over a period of years, beginning not later than 1987, rates of both reversionary and terminal bonus were set at levels that inflated maturity and other claims values to levels that were not sustainable without continuing high returns on investments, with the aggregate cost at maturity or on other claims being continually (and increasingly) passed on to succeeding generations of policyholders. That was the case notwithstanding that rates of reversionary bonus did decrease over time. The excess of policy values over assets increased until, at 31 December 2000, the un-funded portion of aggregate policy values was £3 billion, of which £1.8 billion had been crystallised through claims. The position deteriorated during 2001.

99. By August 1997 actuarial executives of the Society had estimated that as a result of historical over-distribution the aggregate deficit on in-force business at 31 December 1996 was £1,725 million of which over £900 million had crystallised on claims. On the inquiry's calculations that position had deteriorated significantly by 31 December 1997. By September 1998 the executives had estimated the potential cost of the annuity guarantee issue to be £1.5 billion. In view of the estimates made internally, albeit related to different types of adjustment, it would have been clear to the Board, if they had sought and obtained information about the aggregate position on the with-profits fund, that correcting the over-distribution would take many years

on the basis of current bonus policy, even if the Society were able to maintain its stance on the annuity guarantees.

100. I accept that, on the evidence available to me, the Board as a whole was unaware of the estimates of over-allocation of bonus, and in particular of the over-payment that resulted on maturities and other claims. There were no adequate systems at Board level for assessment and reporting of the financial position of the with-profits fund that would have disclosed such matters on routine reporting, and I have found no evidence of specific enquiry or challenge that would have brought the information to light. I note that there have been representations to the effect that it was the appointed actuary's responsibility to ensure that reports were accurate and complete, and that non-executive directors have no responsibility for the actuarial management of the Society. It is not for me to comment on the extent of the directors' duties at the time, which may a matter for the court in the case that has been sent for trial, but the representations have a material bearing on what should be required of directors in future.

101. The Board had formal and actual responsibility for decisions on bonus distribution and, by its decisions, caused the material over-distribution that weakened the Society's financial position and contributed significantly to the ultimate reduction in policy values in July 2001.

Liability Valuation

102. Surplus apparently available for distribution was supported by actuarial techniques that reduced liability values:

i. Quasi-zillmerisation in respect of recurrent single premium business;

ii. Between 1990 and 1996, different interest rates were used for projecting gross bonus rates and for discounting liabilities, with the result that the liabilities in respect of recurrent single premium business were valued at less than face value.

iii. Delayed up-dating of mortality assumptions[15].

Again it has been represented to me on behalf of some non-executives that these were matters for the actuary, and that ensuring that actuarial techniques were appropriate were functions of the appointed actuary, the auditors and the regulators, including GAD. More surprisingly, similar representations have been made by Thomas and Bowley, who were both qualified actuaries, but whose executive functions, they say, did not involve actuarial expertise. They claimed that they took comfort from the skills of the Society's actuarial team, the auditors and the regulators including GAD.

103. The Board instituted no means of oversight over the valuation methods employed by its actuarial staff until the late 1990s. The development of risk management functions and an audit committee did not provide even formally for effective oversight in this area until 1998. The Board had no access to, or means of forming independent views of, the appropriateness of the methodologies employed.

104. The Board relied on reports made directly to them by the Society's senior actuarial staff, and in particular the appointed actuary, without instituting and maintaining any committee system to consider in detail and report on actuarial management (which was in marked contrast to the Board's approach to investment management, in relation to which there was active committee involvement). Headdon has pointed to the monthly reports on solvency and sensitivity and has commented

[15] Ranson and Headdon have both criticised this comment as insufficiently specific, and Headdon has provided the inquiry with further information about the mortality assumptions applied. What was communicated was the gist of possible criticisms, and it was made clear that the materials relied on were available for them to consider before responding to the maxwellisation process. Neither Headdon nor Ranson took the opportunity provided by me to read the material on which the comment was and is based. See chapters 6, 16 and 17.

that the Board was kept abreast of the liability position. I accept that the Board received monthly reports as he says, but the presentation of this data to the Board without a process of pre-digestion was unsatisfactory, not least because of the volume of business transacted, the brevity of the board meetings, and the lack of qualified non executives capable of assimilating and challenging the material provided. The information supplied did not extend to disclosure of the Society's realistic position.

105. The Board accepted advice that the duty of the appointed actuary to the regulator qualified his duty to the Board, with the effect that parts of the regulatory returns (specifically schedules 4 and 6) received no scrutiny from the directors, so that neither in relation to its domestic and Companies Act accounting nor in relation to its regulatory returns did the Board have means of monitoring the valuation of liabilities. I acknowledge that communications between the appointed actuary and the Board improved when Headdon took over as appointed actuary, but that does not alter the thrust of this comment. The liability valuations entered into the Society's financial statements, and those statements were the Board's. That was not affected by the appointed actuary's separate obligations. The Board's responsibilities to policyholders remained comprehensive.

106. I do not propose to rehearse here the extensive representations I have received from Allen & Overy about risk management generally. I have discussed the position in chapter 9. However, I note that they have indicated that, in respect of liability valuation, their clients relied on the appointed actuary, the in-house team of actuaries, the auditors and regulators, including GAD. As in other contexts the factual position of their particular clients as individuals is unknown to me because of their refusal to co-operate with the inquiry.

107. In terms of the Society's articles all delegations of authority were subject to variation or recall. The Board had no system of review of the performance by its officers of the critical function of liability valuation. (In making this criticism, I acknowledge that the actuary's function under article 65(1) was an ascribed function of the actuary, not a delegation by the Board. However, article 65 referred only to the report required in the context of distribution; it did not apply to the regular valuation of liabilities required throughout the year.)

Oversight of Actuarial Function

108. There was a general lack of robust and effective scrutiny of management systems in the actuarial area. Among the weaknesses was a failure until 2000 to require the production of annual financial condition reports or equivalent reports that brought together different sources of information about the current position of the business and assessed business risks going forward. Financial condition reports, so-called, were a recent innovation in 1997, but the precise form of reporting is subordinate to the general problem associated with piece-meal reporting without a comprehensive analysis supported by projections of likely future experience.

109. So far as the actuarially qualified members of the Board are concerned, there was no acceptable evidence that they used their actuarial skills to support the Board by requiring adequate risk management systems to be put in place in relation to liabilities. Through their solicitors, Thomas and Bowley have commented that, though qualified actuaries, they did not get involved in the detailed actuarial techniques and should not have been expected to. They would have questioned the appointed actuary and actuary where necessary, and would have been satisfied with they responses received, otherwise they would have questioned them further. The wholly unsatisfactory nature of the Board minutes makes it impossible generally to identify discussion or who contributed to it. I have not been able to identify any occasion when either individual acted as the comment suggests, and no example has been brought to my notice.

Product Design

110. There was no effective system for review of product design by the Board, with the result that, inter alia:

i. Product design was changed through the late 1980s and 1990s so as progressively to reduce guaranteed benefits within new products. This increased the shift within the bonus mix towards un-guaranteed benefits and aggravated the problems resulting from the reserving policy referred to above.

ii. The Board did not identify the guaranteed annuity problem at critical times in the development of the business, and in particular on the introduction of with-profits annuities in 1987, personal pensions in 1988, managed annuities in 1990 and managed pensions in 1994, the removal of the guaranteed investment return from new policies from 1996 and the removal of reversionary bonuses from 1998.

Allen & Overy have contended that product design was clearly an executive function that a generalist non-executive director would not have been competent to review. Whether or not the firm's clients and other non-executive directors had a duty to review product design is not a matter for me. But I would again observe that liabilities, which are what the products generated, were fundamental to the financial health of the Society. If non-executive directors are not competent to review product liabilities, that should be a matter of concern. It may be something that requires to be addressed by FSA in the context of approval of proposed nominees for Board appointments.

111. The absence of effective scrutiny of new products contributed to a more general failure to put in place adequate arrangements for assessing and managing liability risks. The lack of effective arrangements for monitoring product risk and associated valuation matters resulted in the Board having inadequate information about business risk generally and about problems associated with the annuity guarantees in particular.

Differential Terminal Bonus Policy

112. The inquiry has not uncovered any evidence that the Board was aware that the intention to recover the cost of annuity guarantees from terminal bonus in the event of a sustained low interest rate environment was formed late in 1982 or early in 1983 following on the temporary fall in interest rates in the autumn of 1982. There has been no evidence that management's views on such a policy were communicated to the Board at any time prior to December 1993.

113. The decision to maintain identical premium bases and a single bonus series for retirement annuity and personal pensions business in 1988 was predicated on the view that benefit rights were equal, a view that must have been based on the existence of a management policy that came ultimately to be expressed in the differential terminal bonus policy applicable in the event that the annuity guarantees came into the money. I accept Allen & Overy's comment that the Board was not committed to maintaining the practice of common rates, but the business was sold on the basis that the old and new forms were equivalent. I also note the suggestion that Headdon's paper proposing in December 1998 to allot lower or no bonuses to GAR policyholders was an indication of the Board's understanding that there was an ability to distinguish the series if they thought that fair. The events of late 1998 are not, in my view, a fair indication of attitudes over time. By then steps were contemplated that were not characteristic of policy generally.

114. On the hypothesis that the Board was not aware of the policy in 1988, the decision taken at that time to maintain a single series would have been taken without sufficient consideration of and without taking advice on the differences in policy terms between the old and new products. There is no evidence that the Board addressed these matters. There was extensive discussion of the new policy forms introduced in 1988, in the light of the LAUTRO requirements introduced at that

time, involving the Society's solicitors, but no indication of comparative analysis of the benefits provisions of the older and newer forms.

115. As commented above, this particular matter of the treatment of annuity guarantee liabilities reflected the general lack of a system of control over product design over the period studied. The steps taken by the Board to establish better controls did not encompass the work of the actuarial department until the issue of the annuity guarantees had already emerged.

The Executives

Roy Ranson

116. During the period 1982 to 1992, Roy Ranson was the appointed actuary, with Barry Sherlock as chief executive, and from 1992 to 1997 he was the chief executive and appointed actuary. Throughout this fifteen-year period Ranson was the executive mainly responsible for communicating technical and professional actuarial advice to the Board. It was Ranson who provided reports to the Board, initially supported by Sherlock and latterly supported by Chris Headdon and on occasion Alan Nash, and it was through his reports that the Board had access to information regarding:

i. the financial position of the Society;

ii. the financial risks involved in the decisions the Board was invited to take;

iii. the long-term financial implications for the Society of the valuation and solvency calculations and the distribution practices followed; and

iv. the long-term financial risks inherent in the contracts written by the Society.

In the course of maxwellisation, Ranson has maintained that the comments in this section present a misleading picture of his position in the hierarchy. My views are based on an assessment of the total information available to me, including my assessment of Ranson and Sherlock respectively as witnesses.

117. It may also be claimed, in mitigation of the non-executives, that the Board was dominated by Ranson. If so, that is a matter for other proceedings. I was denied the evidence of some of those directors I invited for interview, and it would be inappropriate to express a view on a matter of this kind on the basis of limited evidence. At interview, I found Ranson to be highly intelligent and articulate, but manipulative. I was not persuaded that his memory was as inconsistent as he asserted, nor that he had put the Society's affairs so completely behind him at his retirement that he could not comment on some of the matters that were put to him. Without the benefit of an adversarial process in which his evidence could be tested by cross-examination I cannot form any concluded view on the reliability of his evidence relating to his relationship with the Board. But I note his own assessment of his approach, in discussion with regulators, as 'autocratic'. That coincides with other information available to me.

118. Substantial amounts of technical and financial information were provided to the Board. This was done primarily by means of periodical reports that were individually less than comprehensive. These failed fully to present the overall financial position of the Society, and in particular the risks inherent in the policies that were pursued in relation to bonus allocation, as would have been brought out, for example, by an annual financial condition report, or equivalent overall report, supported by stochastic or other statistical analysis that took account of the possible ranges of experience over a period of time that reflected the projected duration of the Society's in force business. The typical presentation of deterministic projections based on a 3-year rolling programme was inadequate for these purposes. Further the realistic position of the Society and the other factors identified were not reported on a regular basis.

119. In his maxwellisation representations, Ranson has observed that reporting on many of the financial matters identified, which would have featured in the projections of a different type of office, were of less relevance to the Society's future performance because of the predominance of recurrent single premium business. He has contended that there was no model that would have been suitable. And he has contended that the need for a financial condition report was a matter on which actuaries entertained differing views. I have not sought to form or express a view whether Ranson was in breach of duty in failing to provide a financial condition report. That is a matter for the courts and for his professional institute. In other respects, in my view, the Society's uniqueness lay in the approach adopted by its management, not in the essential characteristics of its business.

120. In advising on bonus mix, and on the ability of the Society to manage payments on maturities and other claims, Ranson persistently emphasised that there was no need to reserve for accrued terminal bonus in regulatory returns, or to provide for emerging liabilities in the Companies Act financial statements. That was technically correct, but the prudence of recognising in financial statements the accrued value of terminal bonus intimated to policyholders, in and after 1989 in particular, was not the subject of advice. Typically that would have been done by holding investment reserve or fund for future appropriation balances against all or some specified part of the accrued terminal bonus. In adopting the approach he did, Ranson advised the Board to fix levels of terminal bonus that were reflected in current claims values and which progressively built up deficiencies of available assets in relation to advertised policy values, as well as inflating the policy values of in-force business beyond the Society's available assets.

121. Ranson did not advise the Board of the risk that persistent practice associated with published statements of practice would develop policyholders' reasonable expectations (PRE) that existing patterns of payment would continue to characterise the Society's bonus practices in the future. In particular the advice that future terminal bonus payments were not guaranteed (that is not contractually due) diverted attention from the risks associated with the generation of non-contractual expectations of future terminal bonus payments.

122. In valuing the Society's liabilities internally, Ranson adopted between 1990 and 1997 the change of practice already mentioned in relation to the valuation discount rates relative to bonus projections that generated an apparently distributable surplus that was not truly reflective of the Society's financial position, and in particular its capacity to allocate reversionary and terminal bonuses. That was especially the case in 1990, 1991 and 1994. The use of an associated higher valuation discount rate in the Companies Act accounts and regulatory returns inflated surplus and profit in those contexts.

123. With particular reference to the regulatory returns, on the evidence available to me, Ranson:

i. from some point in the 1990s adopted a practice of using a quasi- zillmer adjustment in circumstances in which zillmerising was inappropriate, having regard to the fact that the Society's business was predominantly recurrent single premium; and

ii. used future profits implicit items inappropriately and without adequate analysis of the future profits available on in-force business.

Other mechanisms that depended on the same future profits included the subordinated loan obtained to support solvency in 1997.

124. In relation to the Society's position overall, it was progressively weakened from 1983 (the 1982 valuation) by the reduction in the second call (non-technical) reserving for future reversionary bonus. Between 1983 and 1985 the weakening and final abandonment of the second call resulted in:

iii. the inflation of the third call available for the terminal bonus; and

iv. the appropriation of progressively higher proportions of the third call values in terminal bonus allocations.

Together with the adoption of the marketing adjustment in 1986-87 to be applied at Ranson's discretion, for which there was no warrant in the Society's articles, these steps resulted in the Society's total bonus allocations including terminal bonus exceeding available assets at market value at the latest by 1987, from which deficiency the Society never thereafter recovered. I note that Ranson has denied that the marketing adjustment was something to be applied at his discretion, and that the adjustment was implicit within the rates determined by the Board. However, my conclusion is based on his own reports as approved by the Board[16].

125. Ranson did not advise the Board on the requirements of a systematic policy for smoothing of returns to policyholders that provided criteria for the smoothing cycle and permissible deviations from a specified norm against which to measure total bonus allocations. No such policy was adopted and applied by the Board. Ranson has denied this and referred me to his paper dated 15 November 1995. I have dealt with that paper in context. However, selective presentation of the particular years' results for retrospective comment merely underlines the criticism that generally there was inadequate information presented to the Board about the Society's smoothing account, and a lack of Board policy on smoothing. He also referred to the practice of other offices during the current equity market collapse. I have not sought to speculate on the impact that collapse of the markets in and after 2001 would have had on Equitable if it had remained in the hands of previous management following established policies.

126. Ranson did not provide regular and adequate information to the Board about the business risks inherent in the general actuarial management of the Society, and in particular the business risks associated with the terms and conditions of the business written by the Society from time to time. In particular he did not inform the Board:

i. Of management decisions in the period 1983-93 related to the recovery of the cost of annuity guarantees from terminal bonus[17].

ii. That the validity of the 1988 equation of annuity benefits for equal contributions to retirement annuity pensions and personal pensions respectively depended on the decision of 1982/83 that the cost of annuity guarantees would be recovered from final bonuses otherwise payable on retirement annuity pensions.

iii. Of the relevance of the prospective differential terminal bonus policy to the gradual withdrawal of guarantees from new with profits business during the 1990s; or

iv. Of the risks to which policyholders not entitled to annuity guarantees were exposed by the policies and practices adopted.

Ranson has commented that this is unacceptable criticism "in the absence of significant guarantees within the business", a comment that is unintelligible in the circumstances. He has asserted that the Board "would have been aware of the long-established approach that the guarantees... were managed through the bonus system", a comment for which I have found no support in the Board papers. He has denied that the decisions were management decisions, and at the same time contended that implementation was not something that merited report to the Board.

[16] See chapter 3, paragraph 129, footnote 14. In his report for the Board meeting on 28 January 1987 Ranson explicitly recommended that "the £2m released from reserves be utilised to enhance various rates for recurrent single premium business at my discretion".

[17] Ranson, along with other directors, has challenged the reference to the 'cost' of the annuity guarantees as misleading and objectionable. The expression was taken from Headdon's papers. In any event I consider that making good the capital deficiency recognised as arising from the *Hyman* decision is appropriately described as a 'cost'.

127. Ranson has also challenged the characterisation of the differential terminal bonus policy as providing for the recovery of annuity guarantees from terminal bonus, and has sought to justify the equal treatment of RAPs and personal pensions in the circumstances of 1988, and to relate them to other decisions on bonus policy. Changes were made to bonus policy in 1962 to reflect the differential incidence of tax, but that in my view had no bearing on the position in 1988. He has asserted that the articles of association gave the Board power to set distinct bonuses for each individual policy if it considered that appropriate. I consider that to be an inappropriate construction of the articles quite apart from the House of Lords' decision in *Hyman*. Ranson's other comments on this section challenge findings in fact for which I consider there is ample evidence, as set out in the body of the report.

128. In relation to the Society's regulatory returns, Ranson did not apply successive regulatory requirements requiring the valuation of:

i. Guarantees explicit on the face of the with profits pensions business; and

ii. Any options that were from time to time in the money, relative to the Society's primary obligations

As a result, the Society's regulatory returns failed to identify and value the growing guaranteed obligations that resulted from a combination of falling interest rates and lightening mortality experience. Such references as were made to these guarantees in and after 1994 (relative to the 1993 return) failed properly to disclose their nature and extent to the regulators.

129. In his representations, Ranson has contended that the publication of the Government Actuary's guidance in January 1999 indicated that there was doubt about the requirements of the regulations. Superficially that appears to be a fair inference from the fact of publication, and it has some support from GAD. However, the regulators' views were based on the clear terms of the legislation and regulations supplemented by GN1. Ranson has also commented that the Society's position was clear on the face of the returns and no questions were asked. On this matter, I prefer the evidence of the GAD witnesses who have pointed to the obscurity of the references in the returns. The returns were opaque and uncommunicative.

130. The intimation of a quasi-zillmer adjustment to the regulator in November 1992, affecting the valuation bases at that time, was clear, and should have caused comment. But Ranson's comments in schedule 4 to the 1994 and 1995 regulatory returns failed adequately to relate the adjustment made then and subsequently to acquisition expenses, and therefore failed properly to disclose the nature of the adjustment. The amended language of the 1997 regulatory return, while less opaque, did not disclose fully the nature of the adjustment. Further explanation would have been required for the returns to communicate the nature of the adjustment made in the resilience calculations. I note that Ranson has commented that Schedule 4 was written primarily for scrutiny by professionals at GAD. However, the form is part of the published financial statements of the Society, not a private communication.

<u>Headdon</u>

131. Ranson's successor as appointed actuary was Chris Headdon, who had joined the Society as an actuarial trainee in about 1978. He subsequently qualified and, in 1985 after circulating through a number of departments, joined the actuarial valuation department overseen by Ranson. Between then and 1997 when he succeeded to the post of appointed actuary, Headdon had a role subordinate to Ranson. Headdon was not appointed a director until 1999. He took over as chief executive on Nash's resignation in December 2000. From at least 1989 until 1997 Headdon was associated with Ranson in the provision of information to the Board on actuarial matters. He did not make good the lack of information and advice on actuarial matters referred to in the case of Ranson.

132. In November 1993, Headdon identified two alternative approaches to dealing with the annuity guarantee problem. He advised Ranson of the implications of selecting the option that was likely to draw less attention to the issue. That option failed to communicate fully the nature of the differential terminal bonus policy to policyholders. Headdon acquiesced in the implementation of that approach as Ranson's assistant.

133. Headdon has made extensive observations in relation to this finding. He has challenged the comment that there was a problem, suggesting that there was none before the *Hyman* decision. However, there would have been no litigation if there had not been a problem. Headdon has also emphasised his own subordinate role. I accept that he was subordinate, and I do not suggest, as he has alleged, that "every middle-ranking manager should resign on principle whenever senior colleagues do not fully agree with them on every matter outside of their area of responsibility". But he cannot object to responsibility for his own advice. Nor do I accept his contention that the selection of a bonus policy was a separate issue from how it was published to policyholders. That there are different processes is clear, but in a mutual society there should be no difference between the substance of a policy and what is communicated to policyholders about it.

134. From 1997 Headdon was responsible for actuarial advice. He continued to operate the quasi-zillmer adjustment in resilience calculations, which was inappropriate. He continued the differential terminal bonus policy. Headdon was responsible for engaging the mechanism of financial reinsurance to support the solvency position, although the treaty did not, and never was intended to, transfer material risk or result in any actual settlement of reinsurance claims. Rather it facilitated an accounting exercise that appeared to reduce net liabilities while leaving the Society exposed to the gross risk. Emerging reinsurance claims were offset by the reinsurer's right to future profits. Further the treaty was subject to a revolving limit of £100m of nominal reinsurance outstanding at any year-end. I make further comments on this topic below.

135. Headdon has commented that by the time he became appointed actuary Ranson's approach had been in use for four years without material query. That is true: Ranson's returns were opaque and the point was not identified by GAD. But, however it is defined, Headdon's personal responsibility was not avoided by reliance on Ranson's actions and experience. He also commented that responsibility for communications with policyholders remained Matthews'. That also is true. But communications were secondary to policy formation in this context.

Nash

136. Alan Nash succeeded Ranson as chief executive in July 1997, resigning in December 2000. In relation to the aspects of the Society's business that are material for the purposes of this report, I have found little cause to identify events and policies with Nash as distinct from other executive, and indeed non-executive, members of the Board. Though a qualified actuary, who occasionally initialled reports with Headdon, I was persuaded that he was not qualified by experience to make a material contribution to, and had no significant part to play in, the actuarial management of the Society. My comments on Nash are therefore generally the same as for the wider Board, but with particular emphasis on his responsibility for failing to ensure adequate and effective risk management systems were operated during his term of office. In particular he delegated the area of actuarial management to Headdon without such systems being put in place.

137. Nash did not ensure that the financial reinsurance arrangements, put in place by the Society to support its solvency position, were proper and effective as the treaty did not, and never was intended to transfer material risk. The characteristics of the treaty are referred to above and later in this chapter.

Audit

138. So far as it is material, it is not within the terms of reference to form or express any views on the performance by the auditors of their contractual or professional duties.

139. The Society has in process civil proceedings for the recovery of damages. Examination of the pleadings, the judgment of the High Court, the written arguments of parties in the Court of Appeal, and the opinions of that Court, and proceedings in other cases recently concluded, make it plain that my inquiry could not have undertaken the investigation of these issues. An inquisitorial process such as this could never satisfy the requirements for fair and reliable adjudication on parties' respective contentions.

140. Similarly, breach of professional duties is a matter for the professional bodies of which the relevant auditors were members at material times. The inquiry could not take to itself the role of a parallel disciplinary body.

141. There are two proper areas for discussion:

i. The implications for the future assuming that what Ernst & Young did in the light of the knowledge they gained of the Society's affairs was a proper reflection of their professional and contractual duties; and

ii. The scope of their knowledge of the relevant facts and circumstances.

142. So far as the second of these items is concerned, the auditors' knowledge is an important source of corroboration where the information recovered from them coincides with the inquiry's independent findings, and a focus for further discussion where there are discrepancies. The facts found by the inquiry on the basis of Ernst & Young's documents and oral evidence have been rehearsed in some detail, and have been taken into account in assessing other evidence relating to the Society's financial position over time.

143. So far as the first area is concerned, there are lessons to be learned for the future in any event. The lessons drawn will necessarily be conditioned by the validity of the assumption made, that what was done was proper performance of their duties. But that is inevitable.

144. There is inevitably an air of unreality about this approach. The High Court may in the end resolve the current litigation by deciding, among other things, that Ernst & Young were in breach of a duty owed to the Society. That would undermine any conclusion dependent on the hypothesis set out. It would not have a similar impact on any lessons for the future. The current controversy that is the focus for the litigation would require one to consider the future position whatever the outcome in the case against Ernst & Young simply because it reflects differences of view as to the duties of auditors.

145. Assuming, however, that Ernst & Young's position is acceptable, on which I express no view whatsoever, my conclusions are:

i. There has been a comprehensive failure by industry and by standard-setting bodies over a long period of time to formulate and put into effect accounting standards for the preparation and presentation of financial statements relating to long-term business that reflect the realistic financial position of life offices.

ii. Without adequate accounting standards relating to liabilities, including contingent liabilities, audit has been inhibited from effective reporting on life offices' financial statements as a whole.

iii. In particular, failure to provide adequate accounting standards for disclosure and valuation of future terminal bonus payments has resulted

in published financial statements that failed adequately to reflect the realistic financial position of companies reported on.

146. Particular failures associated with practices identified in this report include, in relation to liabilities generally, the failure to require disclosure of the realistic financial position of the Society, and comparative analyses of liability valuations in Companies Act and regulatory statements respectively and in the office valuation. There is a clear need to inform policyholders, and shareholders in proprietary companies, of the relationship between the regulatory returns and the Companies Act accounts in a way that defines their respective functions and identifies the differences that result.

147. In the case of the Companies Act accounts there was a failure to identify and to quantify in an intelligible way differences arising from changes in assumptions, and a failure to relate the consequences to PRE. In particular, between 1990 and 1997 the Society's published financial statements failed to inform policyholders of the analysis of the movements in value resulting from the changes in actuarial assumptions, and failed to draw attention to resulting discrepancies between the policy values intimated to them and the relative liabilities reflected in the accounts.

148. The current audit approach, with delegation of scope of and responsibility for the actuarial function within a life office is deficient. The auditor has been in some instances over reliant on the appointed actuary (and indirectly on the actuarial profession's standards and guidance) for appropriate liability valuations for inclusion in the Companies Act and regulatory financial statements. One example of the risks inherent in this approach was the Society's failure properly to take appropriate account of its annuity guarantees and options. While the regulatory framework required such guarantees and options to be included in the actuarially determined valuation process, audit did not extend to reporting on compliance, and was inhibited from making appropriate challenge.

The Regulatory Regime

149. Throughout the period with which the inquiry has been concerned, prudential regulation of life insurance companies focused on a system of returns, generally and in the case of the Society, supplemented in and after 1991 by visits to life offices. (Equitable was among the first offices to be visited.) The returns required information relating to the long-term business of the Society in response to specific questions. It was through the medium of its returns that the Society was required to indicate, and place in the public domain, what was considered to be the essential financial characteristics of the business for purposes of regulation.

150. As understood by regulators, it was a central requirement of the performance of their function to ensure that individual offices' returns were compatible with the regulatory framework, while acknowledging that the relevant issue was whether the data reported reflected assumptions and decisions that were within ranges permitted by the regulations. It was considered that it was not a proper function of regulation to substitute the regulator's judgement of what was optimal from a regulatory standpoint for the judgement of the management. In relation to the content of the returns those views were valid and sustainable in my view.

151. However, scrutiny of the returns to ensure conformity with the current regulations in the way described did not exhaust the scope of regulation. The powers of intervention prescribed by statute were not defined exhaustively in terms of the regulatory requirements for the completion and content of the returns. I shall discuss the particular issue of PRE later. But it illustrates a point of some importance. The financial information required of offices in the returns of long-term business was focused on the contractual liabilities of the office. PRE was not limited to performance of contractual obligations. The concentration of regulatory scrutiny on the returns might raise questions whether PREs were or might be at risk. But the

resolution of such an issue would depend on inquiries that of necessity lay beyond the formal scrutiny process.

152. A decision to implement the regulatory obligations implicit in the 1973 Act by the established means of the scrutiny of returns was made by Ministers in the course of preparation of the Bill. At that time the major part of bonus allocation in with-profits business across the industry took the form of declared reversionary bonus, and terminal bonus was relatively undeveloped. The Society adopted terminal bonus in 1973. The net premium basis of valuation was particularly adapted to annual premium contracts, and, in general terms, contributed to the realisation of policyholders' reasonable expectations of future bonuses by providing for the release of surplus from which bonuses could be declared over the duration of the contract. In the circumstances, and for that time, the approach adopted and approved has not been the subject of serious criticism.

153. The paper-based approach persisted thereafter despite material changes in the approach to with-profits business generally, and in particular the progressive change in bonus mix towards terminal bonus as with-profits offices sought to compete with unit-linked and other innovative products appearing in the market. At all material times the information required in the returns in relation to the long-term liabilities of the with-profits fund was related to contractual or guaranteed benefits. The quantification of these benefits, as liabilities of the Society, required certification by the appointed actuary. Financial reporting systems were at all material times dependent upon the views expressed by the appointed actuary of the appropriate levels of the mathematical reserves generated by the with-profits business, and of the implicit items taken into account in form 9 in the computation of regulatory solvency.

154. GAD have told the inquiry that it was "the overriding principle of regulation and of supervisory monitoring" that "reliance should principally be placed on the appointed actuary, who was close to the company and had a professional responsibility to monitor its financial position on a day-to-day basis and to establish technical provisions". GAD have also observed that this approach has been a major factor contributing to the strength and vitality of the UK life industry since its introduction in 1973. Similarly those responding on behalf of the Treasury have told the inquiry that:

> "... unless the actuary was acting in some way contrary to the regulations, it was not the task of the regulator (or its actuarial advisers) to substitute its judgement for that of the appointed actuary in areas where the appointed actuary had a clear professional responsibility."

155. I do not dispute that there has been an advantage in not seeking to prescribe a fixed actuarial approach, although I have commented already that the appointed actuary's professional responsibilities were in the first instance towards the board of the insurance company. The appointed actuary's regulatory responsibilities were more limited, and in particular were constrained by the valuation regulations that were the responsibility of the regulators. Moreover the variation in experience and status of appointed actuaries within companies meant that regulators continued to have a responsibility to assess the reliance they placed on the appointed actuary in the particular circumstances of the company concerned. That the system placed too great a reliance on the appointed actuary in practice appears to recognised by FSA in their proposals for reform of this role. From the narrow perspective of Equitable, I can say that this reform seems amply justified.

156. In the circumstances there was a heavy responsibility on the regulators to monitor, or to procure the monitoring of, the valuation of the mathematical reserves and the quantification and treatment of implicit items in order effectively to assess the solvency position of the Society in terms of the valuation regulations. I shall return later to the effectiveness of the approach as a means of monitoring the performance of life offices as business practice evolved, after I have commented on actual scrutiny as it affected the Society.

Structure and Resources

157. Until the late 1990s, the regulatory system involved the delegation by the responsible authority (successively DTI, HMT, and FSA) to GAD of the essential task of actuarial scrutiny of life offices' returns. This persisted until FSA brought the separate elements together and began to implement an integrated regulatory system. Until that reorganisation, GAD reported to the regulator, initially in terms of informal arrangements and later in terms of service level agreements that defined the scope of the delegated duties.

158. The approach to regulation was reflected in the resourcing of the DTI insurance division throughout the period. DTI insurance division was ill-equipped to participate in the regulatory process. It had inadequate staff, and those involved at line supervisor level in particular were not qualified to make any significant contribution to the process. Insurance division regulators were fundamentally dependent on GAD for advice on the mathematical reserves, implicit items, technical matters generally, and PRE, and were not individually equipped with specific relevant skills or experience to assess independently the Society's position in these respects. Given the volumes of work to be handled, which extended far beyond the regular scrutiny of returns, higher grade officers had little opportunity to become involved in routine regulation. HMT's term of responsibility was transitional, and, while preparations for change were put in hand, there was no material change of approach during it, although I note that a need for greater regulatory resource had been identified at that time. For all practical purposes, scrutiny of the actuarial functioning of life offices was in the hands of GAD until the reorganisation under FSA was in place.

159. GAD actuaries were held in high regard by the regulators. They enjoyed the advantages and shared the disadvantages of all who are members of small introspective and exclusive professional groups. They had access to current and developing thought within the profession. They participated in discussions, and in particular took part in professional committees reviewing practice and recommending future policy. Individual members of the department participated in professional projects aimed at developing actuarial methodologies appropriate to changing circumstances. [18]

160. However, from a wide reading of reports and other communications within GAD and between GAD officials and regulators and others, it appears that they were often inhibited by their understanding of what was acceptable within broad and ill-defined standards of practice. Although GAD may point to specific instances where challenges were made, for instance on mortality assumptions or on Ranson's use of an "average valuation interest rate", it appears from my reading of the files that there was a tendency to judge according to the lowest common denominator of prevailing current views among actuaries, and appointed actuaries in particular, on whose individual judgements heavy reliance was placed. As a result, GAD did not appear to have challenged sufficiently the opinions and assumptions underlying actuarial valuation. Although GAD brought in a more detailed style of scrutiny in the early 1990s, the standards of scrutiny still impress me as complacent, lacking challenge, and hesitant in criticism and in following up on any criticism made. This was, indirectly, reflected in a lack of robustness in the regulatory process.

161. In the course of maxwellisation, it has been represented by senior regulatory officers that Government required a 'light touch' approach to regulation, and allocated resources accordingly. Increased resources, it was said, might have improved the chances of identifying problems. I was urged to take into account the

[18] In representations to the inquiry, GAD have drawn particular attention to the new, more detailed style of scrutiny reports introduced from 1993, their participation in professional working groups such as those looking into guaranteed annuities and PRE, and their active promotion of dynamic financial analysis, which contributed to the introduction by the profession of financial condition reports as recommended practice.

political climate that prevailed for most of the 1990s when the Government's objective was to deregulate, to reduce regulatory burdens on business, to avoid interference in private companies, and to let market forces prevail.

162. There have also been representations from individual regulators to the effect that reforms were introduced, within the legislative framework that existed, but that Ministers had repeatedly ruled out primary legislation in this area. It has been suggested that the likelihood of proposals for change winning ministerial approval was reduced further by Ministers' perception that life insurance supervision was a success: there had been only one insignificant life company failure in twenty years. It was said that problems affecting particular companies were identified in time, and solutions found. Virtually no primary legislation in the regulatory area for which DTI was responsible was taken forward by Ministers. I accept that there were specific proposals for change that Ministers did not pursue. And the inquiry has seen evidence that aspects of the regime were reviewed. For instance there was a review in 1990 of the powers under the 1982 Act by comparison with the more recent powers under the Banking Act 1987. But I saw no 'wish list' of legislative amendments that identified fundamental structural reform as a possible subject for legislation.

163. However, the observations appear to me to miss the point. If regulators had identified the need to amend the regulatory system, for example to require realistic accounting in the way now proposed by FSA, and Ministers had failed or refused to pursue proposals for change, the ground for criticism of the department would have remained the same. The balance of individual responsibility would have changed. But no relevant proposals for change were made, and the ground for criticism of the department remains the same. Whether that affects individual responsibility depends on one's assessment of Ministers' general policies. But my concern, in terms of the remit, has to do with identification of any deficiencies I have found and with appropriate recommendations for future change. Allocation of responsibility as between Ministers and officials, while an interesting diversion, is not of the essence of the exercise.

Regulation of the Society

164. I have already set out my conclusions as regards the financial management of the Society. By the time the annuity guarantee issue came to prominence in the late 1990s, there was already a history of chronic and persistent over-allocation of bonus and consequent over-payment of claims that left the Society in a seriously weakened position. That weakened position was more and more manifest in the measures the Society was taking to bolster its solvency position.

165. Before turning to specific aspects of the Society's financial position, I should note that I have received various representations to the effect that the focus of regulation was on solvency, and that the Society was at no point insolvent. I do not dispute that solvency was the focus, but there are reasons why it should not have remained so. First, industry trends were increasingly taking the reality of with-profits business away from a narrow test of solvency, and towards a situation in which PRE was increasing important. As I will discuss below, the focus on solvency did not adequately address this. FSA's proposals for realistic accounting are clear recognition of the importance of looking beyond a narrow concept of solvency. Second, emphasis on the Society's continuing solvency ignores the fact that it is a mutual society, whose members' liability is not limited by its articles of association. A regulatory system that aimed simply at avoiding insolvency would fall far short of the objectives that the public would assume for it, and short indeed of the objectives that I believe Parliament set for it.

166. Within the framework of the existing regulatory structure, in relation to the treatment of contractual or guaranteed liabilities, there are six areas of specific concern about the regulatory response to the Society's practices in relation to the

computation of its mathematical reserves and the computation and treatment of the implicit items. These are:

(i) the interest rate differential (between the bonus rate projected forward and the rate of return used to discount liabilities back to present values) between 1990 and 1997;

(ii) the quasi-zillmer adjustment (through which acquisition costs for recurrent single premium business were annuitised) from the early 1990s;

(iii) implicit items for future profits employed in and after 1994;

(iv) the subordinated debt;

(v) the GAR liability valuation, and

(vi) the financial reinsurance treaty.

Individually and together the steps taken or omitted to be taken by the Society in respect of these items supported regulatory solvency of the Society. As a consequence of these practices, some of which were at the expense of, or in anticipation of future profits, future maturities and other claims were put at risk. The treatment of these factors served indirectly to conceal the growing weakness of the Society in realistic terms.

167. In view of representations made in the course of maxwellisation of senior regulatory officers, it is necessary to spell out more fully the nature and impact of the factors identified, most of which were within the limits allowed in the valuation regulations and published guidance.

Interest Rate Differential

168. Ranson had pursued a consistent practice of equating the bonus rate projected forward and the valuation discount rate in his bonus reserve valuation, and reflected the valuation discount rate in the net premium valuation appended to the returns. In 1990 he introduced a 1¼% differential deliberately to release surplus. Similar rates released further surplus in 1991. Balance between these rates was nearly restored in 1993, when there was only a ¼% differential. In 1994, another year that showed a loss in realistic terms the exercise was repeated, and balance between the rates, in accordance with prior consistent practice, was not restored until 1997.

169. As a result, recurrent single premium business was valued at less than face value and surplus was anticipated, in conflict with the accepted actuarial opinions expressed by GAD officials. The Society's liabilities were depressed in value over two successive periods of years at the start of which there had been significant losses in market values of assets. Equitable's practice was accepted on the sole basis that the valuation discount rates, per se, could be justified under existing regulations by reference to yields on selected assets, without consideration of the longer-term implications of adopting the methodology.

170. In the course of maxwellisation, it has been represented by senior regulatory officials that DTI was aware of the change, and that GAD had considered it and thought it permissible and reasonable in the circumstances, that is in the adverse investment conditions of the time. In their own representations GAD have observed that the practice did not conflict with the relevant regulations in force at the time, and therefore there were no grounds for challenge. Whatever the judgement reached at the time, it is clear, on a review of the Society's realistic position, that the weakening that resulted had serious long-term consequences that would have been disclosed on a broader review than that adopted at the time. The contemporary view reflected a concentration on the global position of the Society that gave inadequate weight to inter-generational implications of decisions.

171. It may be helpful at this point to illustrate the significance of all these items by reference to the interest rate differential. In the regulatory return, the change of practice introduced in 1990 released £557m of surplus in a year when the Society had suffered negative investment returns, and was, indeed, a mathematical product of the recognition of the loss of equity value. The Society was enabled to allocate a substantial rate of return to policyholders for 1990 and 1991. This inflated policy values relative to available with-profits assets. On becoming a claim, policy value was crystallised and whatever un-guaranteed elements there had been, in the form of accrued terminal bonus, became contractually due, subject to any market value adjustment that was applicable and was applied at the time. The total adjusted value left the with-profits fund. Claims values were inflated in this way throughout the 1990s, and on into 2001. Capital was eroded and the cost fell on continuing policyholders. The fund overall was weakened irrespective of whether fresh surpluses emerged in succeeding periods. The failure to appreciate that a change of valuation assumption of this kind had real implications for different generations of policyholders as well as computational implications for the with-profits fund as a whole appears to persist in the representations I have received.

Quasi Zillmer Adjustment

172. In 1992 GAD had information that the Society's valuation bases included an adjustment in valuing recurrent single premium business that released money at the outset in a similar way to the release produced by a zillmer adjustment. In a letter dated 6 November 1992, Ranson commented on the practice in relation to the 1991 valuation. The point was not pursued in GAD's response on 3 March 1993, and appears to have been dropped at that time. Thereafter there were opaque references to the practice in returns for 1994 and 1995 and more explicit references from 1997. After the correspondence in 1992, the nature of the adjustment as a zillmer-type adjustment was not identified until late in the scrutiny process on the 1999 return. The practice came to be identified at that stage as a quasi-zillmer adjustment of ½% of fund in the resilience calculations, and was eventually held by GAD to be irregular in relation to the financial statement at 31 December 1999, when the amount involved was approximately £950m. The accumulation of a credit against the Society's liabilities based on the assimilation with a zillmer adjustment had from the early 1990s inflated its solvency position. By late November 2000 the quasi-zillmer adjustment, which had been disclosed in Ernst & Young's report for the sale process, had been the subject of discussion between regulators and potential bidders.

173. The information provided by the Society to GAD, apart from the letter of 6 November 1992, was not clear until Headdon was challenged on the 1999 return. The GAD actuary engaged in the correspondence with Ranson in 1992 declined to complete the interview process with the inquiry, and I have received no other explanation of the failure to follow the point up at that time. On the information available from the documents, GAD had intimation of the practice in November 1992. It was suggested by one witness that Ranson was told the practice was unacceptable and agreed to discontinue it. But I have not traced any record of the challenge nor of the agreement to desist, and it is now clear that Ranson did not abandon the practice in the early 1990s.

174. This is an area where the lack of powers of compulsion has prevented me from following up a detailed study of the background to an issue. However, the general effect of the adjustment is reasonably clear; its unacceptability was affirmed in the end; and there is sufficient evidence that one manifestation of Ranson's approach was known to GAD in November 1992 at the latest. I cannot accept the representation during the maxwellisation process that GAD was not aware of the practice and therefore did not notify DTI of it. This seems to me to be a clear example of the system failing to follow up information that was relevant to financial regulation.

175. It has also been suggested in the course of maxwellisation that in 2000 the Society was able, by re-hypothecation of assets for resilience purposes, to off-set the reduction in the resilience reserve that arose on correction for the quasi-zillmer adjustment. To a value of £750m that was the case. However this misses the point. Over the years the Society had avoided structured hypothecation of assets in order to maximise the scope for discretionary variations in benefits allocated to different policyholder cohorts. It is no answer to the criticism of practice throughout the 1990s that the Society had resort to yet another actuarial technique to reduce liability valuation, in place of the unacceptable quasi-zillmer adjustment, in respect of solvency in 1999.

Future Profits

176. The Society was allowed orders under section 68 for future profits implicit items on what appears to me from the record to have been a mechanistic approach that failed to test the actuary's certification of the availability of the future profits, given the nature of the Society's predominantly RSP business. The supporting projections were not sought. While this criticism is general, it takes on greater force in the later 1990s when the Society's dependence on the implicit items was greater.

177. The Society's practice has been discussed in chapter 6. The actuarial certificate required to support an application for a future profits implicit item had to state that the sum sought, as well as meeting the arithmetical requirements of the regulations, did not exceed the present value of the profits expected to arise in the future on in-force business. The valuation of the in-force business involved assumptions about discount rates and other factors that were intended to be inherently prudent. In the Society's case, it appears that the 'future profits' were taken to arise from the difference between the implicit assumptions and more realistic expectations of future returns.

178. As applied throughout the relevant period, the assessment of present value took no account of actual anticipated financial conditions generally, as affecting the particular office. The approval of an implicit future profits item in September 2000 after the Society had lost the Hyman case and was in the course of a sale process highlights the artificiality of the regulatory requirements. By that time it was known that the Society itself would not continue in business: it would either be sold or closed to new business. Even in the event of a successful sale, the Society would be a new entity that required assessment of its current business according to its altered financial position. But in the event that the Society had to close to new business, as in fact it did, there would be no basis on which it could have been assumed to have a future maintainable flow of surplus from in-force business, whatever the margins in the valuation at 31 December 1999. Investment policy would have been constrained by solvency requirements. The quantum and incidence of expenses would have altered. The potential for future profits to be realised would be adversely affected by the altered circumstances in which operations had to be carried on. One element of a full and proper assessment would have been the value of the margins in the valuation process. But the circumstances relevant to the Society's ability to realise those margins as profit would have changed.

179. I have received extensive representations that the grant of a section 68 order for the future implicit profits item in September 2000 was proper and in accordance with the regulations. I do not suggest that that was not the position. Indeed it appears that in the context of current guidance and the regulatory framework in force regulators could not have done otherwise, at least without considerable investigation of the background to the second part of the actuarial certificate which was not then the practice..

180. I consider, however, that there is at least an air of unreality in a system that prescribes valuation criteria, to ensure prudence in the interests of policyholders, and then proceeds to allow for the reduction of the prudent margins implicit in the valuation exercise on an accounting basis that allows one to ignore fundamental structural changes in the business that must impact on the ability to realise, as

profit, the values off-set against the liabilities as initially calculated. Nor is it an answer to point out, as some maxwellisation responses did, that the certification requirement represented a stricter requirement than that prescribed in the 1st life directive. Failure to question the robustness of the underlying assumptions meant that this requirement was ineffective.

181. The effect of the order has been described in maxwellisation representations of senior regulatory officials as follows:

> "In effect, the implicit item simply recognised that there were margins in the basis for valuing liabilities in respect of existing business, and that these could be released to cover unexpected future losses. Of course, any such unexpected losses would also have an effect on the level of future bonuses that could be payable. However, this was a natural part of the operation of the business whereby policyholders would participate in the overall profits or losses."

As I understand it, the margins were released in the period in respect of which the order was granted, and by that means ceased to be available within the valuation to cover unanticipated future losses. Current recognition of the implicit profits increased the exposure of continuing policyholders to future risk.

182. However, perhaps the more important point that arises is the general one that the more a life office relies, and has to rely, on elements of value such as this to maintain regulatory solvency, the greater the need for regulators to examine closely its realistic financial position overall in terms of their powers of intervention.

Subordinated Debt

183. The Society was authorised to ignore subordinated debt in calculating its form 9 solvency position. The authorisation was within the scope of the relevant regulations and guidance. I do not criticise any of the formal steps taken or the propriety of the order granted.

184. However, as with the other items, the Society's interest in raising this form of debt should have alerted regulators to the Society's weakening position overall. It was an extremely complex and expensive exercise. It raised a small sum relative to the Society's resources at the time. Its purpose was to support regulatory solvency in anticipation that that would come under stress. There was no indication that it was seen as an indication of impending solvency problems.

185. I am also concerned that the departmental treatment of the transaction suggested a lack of appreciation of the need properly to protect members of the Society from liability for the debt. The Society's members have unlimited liability for its debts to third parties. Regulators failed adequately to consider whether or not members might ultimately be personally liable for the debt so far as it was not recovered from the Society. The Society intimated to regulators on 10 July 1997, in a proposed amendment to the offering circular, a provision designed to provide protection. There was no response to the proposal. Legal advice was not taken on its effectiveness, or on the effectiveness of the arrangements generally to protect members as individuals.

186. Departmental records show that an erroneous view was held that being a member of a mutual did not involve any obligations other than the obligation to pay premiums. It has been represented by senior regulatory officials that that was not the general view, but an error on the part of a junior official. However, it was the view communicated in name of the department to German regulatory officials following a request for advice. It is a matter of some surprise that responsibility for an inter-governmental representation was committed to a junior official without the degree of supervision that would have identified the error and corrected it, if indeed the error was specific to the individual involved.

187. The subordinated debt supported regulatory solvency from the date it was issued, and consistently thereafter. It was approved when the Society was moving towards a weakened position overall. The purpose of this class of hybrid capital was

to provide an equivalent of equity capital for the long-term operations of insurance entities. In the case of Equitable there were short-term objectives related to support of solvency that should have alerted regulators to the Society's weakening position.

GAR Liability Valuation

188. Having eventually taken a strong position on the interpretation of the relevant regulations and the implications for Equitable's liability valuation, GAD and FSA did not impose the intended requirement for near 100% valuation and tolerated significant discounting of the liability on take-up rate hypotheses that were inconsistent with the official view.

189. But before that stage, regulators and GAD were told in November 1993 that the Society did not reserve for its guarantees, considering that they did not 'bite'. The information was not followed through and did not, as it ought to have done, inform the scrutiny of the 1993 return in 1994.

190. It has been represented to me in the course of maxwellisation that for all practical purposes DTI and GAD had no knowledge of the existence of the annuity guarantees, or of the Society's treatment of them by means of the differential terminal bonus policy, until 1998. It has been said that had they known of them, especially after the renewed fall in interest rates in 1995, there would have been scope for the problems to have been addressed at a significantly earlier date. I agree with the latter proposition: there would indeed have been scope for the problems to have been addressed earlier. But I do not accept that the existence of the annuity guarantees was unknown to the authorities until 1998, in light of the specific information provided in 1993. There is acceptable evidence that regulators knew of the general problem with guarantees in 1993. Nor do I accept that the information supplied by Ranson in 1993 (as recorded by the regulators) was too garbled for its significance to be apparent. At the least it should have prompted more probing questioning.

191. More generally, the Bolton Committee on annuity guarantees was set up in January 1997 by the profession because it had been recognised that annuity guarantees in older business were becoming valuable and because up to that date there had not been an attempt to set appropriate reserving standards in the light of the Insurance Companies regulations. It is clear that the existence of a problem had to have been recognised by the profession at the latest during 1996. Given their access to the returns of the whole industry it would seem surprising if it were the case that, as has been represented to me, regulators were not on notice of the annuity guarantee problem at all until 1997. This suggests either a wide-spread conspiracy to conceal the problem from regulators, or a lack of insight into the reality of the regulated entities' businesses. Since I have acceptable evidence that particular offices recognised their annuity guarantee obligations and made provision in their mathematical reserves for their value, the notion of an industry-wide conspiracy of silence must be rejected.

Reinsurance

192. Reinsurance is well-established in all forms of insurance. Its traditional function has been to redistribute total risk, passing all or part of the insurer's risk to the reinsurer by conferring a right of recourse against the reinsurer on emerging claims. In that case, the insurer's liabilities and technical reserving requirements are reduced.

193. In the course of maxwellisation, I have received representations from senior regulatory officers emphasising that that was not the nature of the contract in Equitable's case:

> "The treaty was... a financing operation. This was known and understood at the time by the regulator. In the Society's case the reinsurance treaty was an appropriate way of 'phasing in' the impact of the higher level of reserving that HMT rightly and firmly insisted on. It was a means of ensuring that the

> resultant cost, in the form of bonus cuts, was not imposed on a single generation of policyholders whose policies matured that year, but was instead spread over a period of years. It provided that the Society could draw down funds in years then the take-up of GARs exceeded a stated level with repayment to be made from future emerging margins. ...
>
> Thus the "risk" the treaty was intended to meet was not so much an increase in the take-up of GARs ..., but rather the non-emergence of margins in the future. Increase in GAR take-up was the trigger for drawing down funds...
>
> These reinsurance agreements then fall to be valued under the relevant regulations for the valuation of liabilities. Where these regulations allowed a value for the reinsurance agreement, then a firm and its Appointed Actuary can legitimately take credit for this agreement in its financial returns..."

I have not been able to identify such an analysis in the documents reviewed, but I am prepared to accept it as the officers' position at the time

194. Regulation 64 of the Insurance Companies Regulations 1994 provides that in valuing liabilities account shall be taken of "any rights under contracts of reinsurance in respect of long-term business". As apparently understood by regulators, the Equitable/ERC treaty did not confer any rights in relation to the current long-term liabilities of the fund. If it did not transfer risk and confer any rights on the Society, it is difficult to see how it could be regarded as reinsurance for the purposes of regulation 64, never mind justify the level of credit that was given to it. Designating the contract as a reinsurance treaty was not conclusive as to its substantive effect. In those circumstances the question of whether the side letter discussed in the full account of the reinsurance topic ought to have limited that credit is an irrelevance in terms of the regulatory assessment of the Society's financial strength.

195. However, on a more general basis the effectiveness of the treaty to support Equitable was questionable. In the first edition of the treaty, cover extended only for so long as the Society's bonus practice remained unchanged, which meant that it would not apply in the event that the Society lost the *Hyman* litigation. The regulators appeared to have proceeded on the assumption that the *Hyman* litigation would resolve itself in favour of the Society. Even without the benefit of hindsight, the contingency that the Society might lose the case, undermining the reinsurance cover, should surely have been regarded as material. Regulators required that the contingency of losing *Hyman* be noted. However, it was not reflected in the value that was taken into account.

196. Further, the nature of the treaty meant that to the extent that liabilities for the reinsurer emerged, the reinsurer would have a claim on future surpluses on the fund, and in that way the treaty, like the other items discussed above, supported present regulatory solvency at the expense of future generations of policyholders. In essence the treaty was not dissimilar to any facility agreement that could be drawn on, subject to an obligation to repay the sums drawn down. It would be unusual to treat the un-drawn balance of an overdraft facility as an asset.

<u>Terminal Bonus</u>

197. The comments so far relate to the regulatory system as it was developed and applied in practice. Notwithstanding various representations claiming the contrary, up to the end of the inquiry's period of interest the system was geared in practice to the assessment of regulatory solvency almost exclusively by reference to contractual or guaranteed liabilities. In the parlance of the Society's documents and practice, 'contractual', 'guaranteed' and 'consolidated' were synonyms describing the situation in which a policyholder had a contractual right to benefit, either in the specific terms of his contract or through the operation of the mechanism of declaration of bonus by the Society's Board in terms of the articles of association.

198. From about 1983 Equitable began progressively to shift the balance within its bonus mix from guaranteed benefits to un-guaranteed terminal, later final, bonus. This reflected a general trend within the life industry, though the balance varied from office to office. The trend in the case of the Society was associated with a parallel trend towards ever-increasing allocation that initially eroded its explicit reserves for future reversionary bonus held at December 1982 until they were exhausted by 1985, absorbed general reserves in 1986 and 1987 to supplement current surplus, and by 1987 at the latest brought the aggregate policy values in the with-profits fund over the value of the available assets at market value. Despite the good returns of 1989 that position was not wholly reversed in that year. Thereafter the adverse results of 1990, 1991, and 1994 coupled with over-allocation of policyholder returns resulted in a position in which the aggregate policy values in the with-profits fund were never again covered by available assets.

199. This state of affairs was not disclosed by the returns because total policy values reflected accrued final bonus for which information was not sought. Regulators and GAD obtained information from time to time about the overall position. For example information was provided for the period 1989 to 1991 in the context of section 68 applications. But there was no consistent provision of relevant data, and none was sought.

200. Concentration on the contractual or guaranteed liabilities arising under with-profits contracts resulted in financial statements that failed to take account of future liabilities that would crystallise in respect of terminal or final bonus payments on claims. Such payments were accounted for on a cash basis, irrespective of their absolute or proportionate value relative to total claim value. Final bonus, from its introduction by the Society as terminal bonus in 1973, escalated through the 1980s and 1990s from being a low-level benefit of relative insignificance in total policy proceeds, to become a major component of importance and value and one of the defining characteristics of the Society's with-profits business.

201. The regulatory system remained in force, unaltered in this respect, throughout the reference period. In the case of Equitable, the approach of GAD and regulators remained the same after December 1994, when they were aware that the Society's financial position was weak and that there was a need for vigilance in scrutiny and supervision. Discussion of total policy values, for example in November 1996, was superficial and lacked challenge. A particular aspect of setting aside total policy values was failure to make any relevant inquiry as to the smoothing parameters, in terms of cycle and proportion, employed by the Society from time to time. In that way regulators and GAD were left without information whether the smoothing practice was based on reliable assumptions as to future trends. Had they made relevant enquiries, the lack of any coherent smoothing policy would have been apparent.

202. The systemic failure to require life offices generally, and the Society in particular, to account for accrued final bonus in advance of payment, especially in and after 1989 when the Society adopted the practice of publishing policy values on an annual basis, resulted in the regulatory returns becoming progressively less relevant as a reflection of the business actually carried on by the Society. At no time during the reference period, and indeed at no time until the new regulatory regime under the Financial Services & Markets Act 2000 was instituted, did regulators devise amendments to, or propose to modify, the regulatory requirements so as to require the Society to account, for regulatory purposes, for the characteristic transactions of the business.

203. This was a particular deficiency in the case of the Society. Regulators and GAD were informed by the Society of the characteristics of its new bonus system as applied in and after 1989; they were aware that a total growth rate was allocated on policies and that a part of that was designated as guaranteed bonus; and they were told that the system distinguished the Society from the practice of others in which

separate declared bonuses and final maturity bonuses were aggregated to determine policy proceeds, to the extent that GAD's questions based on general practice were dismissed by the Society as irrelevant. The uniqueness claimed for the Society's approach should have alerted regulators to the need to consider whether the unique attributes of the practice created unique risks requiring particular scrutiny. However, the Society's uniqueness was taken, generally, to be sufficient explanation of its deviation from industry norms.

204. As described by the Society, total policy values were central to the presentation of its results to policyholders, and were an obvious and necessary focus of regulatory interest if the Society's ability to sustain current practice into the future (especially in and after 1990) was properly to be monitored. No clarification of the Society's explanations and contentions was sought. Total policy values were not monitored. When the issue was discussed in November 1990, no attempt was made to recover the documents issued by the Society. Readily available were the bonus notices and 'dear policyholder' letters issued to members, the annual accounts, and other explanatory material discussing the new system.

205. Regulatory practice in this respect reflected the requirements of the current regulatory structure. But it seems not unreasonable to suggest that those in control of any supervisory regime have a duty to monitor the conduct of regulated businesses and to take steps to ensure that the systems of regulation that are in force and enforced remain relevant to the changing requirements of the industry. If that is not done, there is a risk that regulation will become out-dated and ineffective, and that it may of itself tend to promote practices that take advantage of its deficiencies. Specifically in this case, freedom from active monitoring of accrued terminal bonus encouraged the Society's drift towards un regulated final bonus, and exposed it to the risk of over-allocation of returns to policyholders, with a particular impact on current claims, to the detriment of continuing and future policyholders' interests.

206. With the implementation of the third life directive[19], and following on from the report of the *Groupe Consultatif*[20] in 1990, there was an opportunity to make domestic provisions, as permitted by the directive and encouraged by the report, which would have required prudent reserving for, or some realistic account to be taken of, final bonus. This would have exposed the weakness of the Society at a much earlier stage and would have prompted corrective action. DTI did not take that opportunity, taking the view instead (according to representations on behalf of the Treasury) that "some appropriate allowance should be made implicitly in the parameters of the system". The UK regulations implementing the directive left the position as it had been previously.

207. There were other consequences of this approach. In particular, in 2000 FSA and GAD were incapable of making an independent assessment of the Society's prospects of sale because of their lack of knowledge and understanding of the totality of the Society's business.

208. Representations made in the course of the maxwellisation process have challenged the thrust of this analysis. Reference has been made to advice sought from counsel in 1987, and to the attitude of the insurance industry to implementation of the 3rd life directive. That advice was sought and that the insurance industry was opposed to recognition of accruing terminal bonus is not open to question. But there was a need to be met, and nothing was achieved in the way of modification of the system to meet that need. And the analysis of the events leading to the financial position of Equitable in 2001 has identified the results of that deficiency.

209. The same applies to the claim in GAD's representations that terminal bonus was subject to regulation through the responsibilities of the appointed actuary. I

[19] Council directive 92/96/EEC

[20] See chapter 10, paragraph 22.

note their view that total policy values were "not a natural focus of regulatory interest" during this period, but that despite this information on total policy values was collected. I accept that information was obtained from time to time, as I have recounted in this report, but this was not done consistently and, most importantly, the information was not used to form a realistic appraisal of the Society's financial position and its approach to allocating bonuses.

Policyholders' Reasonable Expectations

210. Independently of the regulator's obligations to review the financial statements of the Society, it was at all material times its obligation to consider whether the interests of the policyholders and potential policyholders required the use, or the consideration of the use, of the powers of intervention conferred by successive Insurance Companies Acts. Until the reorganisation under FSA, which will result in material change if implemented, the forms and statements required in the annual reporting process were not designed at any time to elicit information relevant to regulatory intervention, except in respect of solvency. In particular, the forms and statements at no time sought to elicit information necessary to enable regulators to form a view on whether the reasonable expectations of policyholders and potential policyholders would be likely to be met or frustrated. The questions introduced latterly would not have elicited relevant specific information.

211. The power of intervention on the ground that the office was unlikely to be able to meet PRE was sought by DTI, the statutory provision was drafted by DTI, and Parliament was pressed to grant wide discretionary powers including this power by DTI. Extant departmental files set out the background and made clear and explicit the intention that there should be a power related to expectations of non-contractual benefits. Despite that background, the records disclose repeated references to the lack of a statutory definition as apparent justification for inaction on PRE grounds.

212. Until 1993 and the GAD bonus survey there was no attempt, independent of the returns, to collect and assess information related to regulated entities' bonus practices. After 1993 there was no attempt to assess whether the Society had created reasonable expectations that were likely to be frustrated until the beginning of 1997, when a project was begun and then discontinued prematurely, with the result that at no time during the material period did regulators carry through to completion a study of PRE that might be considered to have been generated by the Society's communications and practices. This was despite a clear recognition of the relevance of these factors to the statutory test of PRE under the Insurance Companies Acts. As it was, regulation failed to address the issue of whether there were grounds for intervention in the Society's business at any material time.

213. The need actively to monitor PRE was underlined by the limitations inherent in the regulatory returns system. The more limited the testing of regulatory solvency by reference to contractual benefits, the greater was the requirement to consider the reasonable expectations of policyholders and potential policyholders that were not secured by present contractual rights.

214. Thus, potential policyholders contemplating investment in a with-profits policy with the Society would have been entitled at any time during the 1990s, having regard to the Society's publications, to expect a return at maturity that reflected the earnings on his contributions over the duration of the policy, subject to some smoothing. The Society's regulatory solvency position would not have discouraged that view. However, the Society's realistic position would have indicated that there would be, for the indefinite future, a prior charge on the investment returns on that policyholder's contributions to compensate the with-profits fund for prior over-allocation of returns on with-profits business. In the context of a well-defined smoothing policy that risk might have been acceptable. Regulators were never in a position to form a view on the issue, and therefore could not form a view whether the conduct of the Society's business was such that policyholders' reasonable expectations were likely to be fulfilled.

215. GAD and the regulators persisted in a reactive stance in respect of PRE when, by 1998, there were serious concerns whether the Society could meet expectations. This represented a major deficiency in the regulatory structure and the systems in place to enforce it. In day-to-day regulatory practice, officials operated within the constraints imposed by the existing system, and they had no alternative but to do so. But they were uniquely placed to understand how, over time, the Society's business was conducted. They did understand that the Society was weak.

216. Regulators were also well-placed to influence the reform of the system to meet its major deficiencies. In the course of the maxwellisation process representations have been made that from the early 1990s there was significant activity in relation to ensuring respect for policyholders' reasonable expectations in relation to demutualisations and other major reorganisations. Again that was clearly the case. Indeed the factors then identified as bearing on PRE were generally those that I have sought to highlight in discussing the subject. But extension of the exercise to offices that were not engaged in major reconstructions was not evidenced by the record, and it is that area that has caused me concern.

217. It was by Ministerial decision that it was resolved, in accordance with GAD's wishes, that PRE would be monitored from the annual regulatory returns. Since no specific provision was made in the returns, at least until 1996, for the provision of any information material to PRE it was left to the appointed actuary to volunteer information on which to judge whether the office was likely to be able to meet PRE. That position did not change materially in 1996. In the case of an office such as Equitable, in which the appointed actuary was also chief executive and reporting actuary for Companies Act purposes, the scope for differences of opinion whether the bonus policy of the office was consistent with policyholders' reasonable expectations was not great. In such circumstances it is not an adequate response for GAD to say in their representations to the inquiry that the regulators and GAD were not responsible for distribution policy.

218. When Equitable's practices in dealing with the annuity guarantees came to be of interest in 1998 and later years, regulators and GAD had to approach the issues raised as novelties that challenged them both in principle, and practically, because they had no relevant material by reference to which to form a view. The same position would have arisen in relation to accrued final bonus had they come to terms with the emerging view that PREs could arise in relation to policyholders' interests that were not contractual.

219. Only with FSA's approach to realistic balance sheet accounting (due for implementation in 2004) will regulators begin to deal with the issue, in the context of the test of treating policyholders fairly.

220. In their separate representations, GAD and the Treasury have told the inquiry that the relevance of terminal bonus was always recognised by GAD and the regulators, but that PRE in respect of terminal bonus was not created by the Society's bonus practice. They point to the notes that stated that terminal bonus was not guaranteed. However, GAD and the Treasury also recognise that PRE was not restricted to guaranteed benefits. It is not necessary to conclude that policyholders would have reasonable expectations of receiving a precise amount of bonus to take the view that reasonable expectations would still have been created. The point is highlighted in GAD's own representations:

> "It was generally accepted in the life insurance market that past levels of terminal bonus did not create reasonable expectations for the future, as they would be entirely dependent on market conditions, subject to a degree of smoothing, which varied considerably from company to company."

The reasonable expectation would not be that the precise policy value quoted would be payable, regardless of market conditions or smoothing, but that any reduction would reflect adverse market conditions. A position where the Society could not afford to honour the policy values without rising market values or inter-generational

transfers would not have been understood by the Society's policyholders on the information provided to them, and would not have informed their reasonable expectations.

The Scrutiny Process

221. The scrutiny system was slow, and its results emerged late relative to periods under review. As a result one scrutiny was frequently overtaken by the next, and outstanding points of criticism or challenge raised in the earlier process were departed from either because they had been dealt with differently in the next returns, or because they had been overlooked in the context of the new returns. Successive GAD actuaries did identify relevant issues, but consistently these were not followed through and were allowed to evaporate. No problem was considered so serious that it could not be left until next time.

222. The service level agreement signed between HMT and FSA on 18 December 1998 set out the nature and scope of duties incumbent on regulators for the effective performance of the duties imposed, and exercise of the powers conferred by, Parliament. Although the 1998 service level agreement was set in the context of FSA's planned statutory objectives and operational aspirations, the delegation by HMT drew on the 1982 Act for the duties and powers contracted out. During the transitional period to N2, there was no wider statutory authority. It has been represented to me that the 1998 agreement reflected considerable regulatory developments since its 1995 predecessor, but it is difficult to see that apart from resources limitations and departmental policy considerations, the regulatory duties would not have had similar scope before the agreement took effect.

223. It has been represented to me that the scrutiny timetable was constrained by primary legislation. The Insurance Companies Act 1982 allowed six months for lodging annual returns. Most companies had the same accounting date. There was necessarily a prioritising of business, involving an initial scrutiny followed by detailed examination on a selective basis according to need. Delay was inevitable. It has been said that it was an unavoidable feature of this system that by the time the earliest scrutinies were completed the information in then was relatively out-of-date as a natural consequence of the legislation. Meantime, market conditions would have moved on, and that might have accounted for at least some of the failures to follow up particular issues that I have identified for critical comment. This defence eloquently highlights the limitations of the system.

Personality Issues

224. The legislation required notification to the regulators of appointments of directors and managers, and required approval for appointment of a new chief executive, managing director or other controller. Appointment could be opposed on the ground that the nominee was not a fit and proper person to hold the office, and (from 1994) on grounds relating to ensuring the sound and prudent management of the office. These provisions implied a responsibility to assess the capacity of those proposed for office as directors and managers. I consider that the Board of the Society failed adequately to ensure the appointment of non-executive directors with the range of skills necessary to procure informed challenge of executive management in relation to the actuarial operations of the Society. The regulatory files inspected by the inquiry suggest that little or no consideration was given to this aspect of the supervisory role, either routinely or at particular junctures, throughout the period for which records are available.

225. In relation to the chief executive for most of the relevant period, Ranson, regulators accepted a situation in which he came to hold simultaneously the offices of chief executive and appointed actuary, at a time when he was also reporting actuary for the purposes of the Society's Companies Act accounts. With few exceptions, he was, until a late stage, the only officer of the Society to meet regulators or GAD, and he acknowledged in discussions with regulators and GAD that he ran the Society in an autocratic manner. Despite the obvious dangers

inherent in such a concentration of authority and influence, and the lack of any qualified challenge within the Society, and officials' clear understanding of the unsatisfactory aspects of the situation, no steps were taken effectively to prevent it from coming about.

226. When in March 1991 the Society intimated that Ranson, already appointed actuary, would succeed Sherlock as chief executive, the Government Actuary, Chris Daykin, wanted to avoid the situation and Ranson was informed. Correspondence ensued in which a temporary expedient was set out. When DTI intimated that Ranson's appointment would be accepted on a temporary basis, he protested that the condition challenged his status as a 'fit an proper person' to hold the office. Within GAD, Daykin had stated that in such an event he would speak to Ranson.

227. Pickford of GAD and Ranson discussed the question on 6 June 1991 at an Institute of Actuaries function, and Pickford intervened. He supported Ranson's view that a point of principle was involved, and on 17 June the condition was removed. Ranson's appointment was confirmed, and his position was thereafter unassailable. The joint holding of these offices resulted in a lack of internal challenge of the actuarial management of the Society and a greater potential for conflict of interest, and increased the responsibility of the regulators to check independently and objectively the validity of the assumptions underlying the calculation of mathematical reserves, implicit items and PRE. However, challenge was ineffective. Ranson was frequently aggressive in his dealings with regulators. He was dismissive of regulators' views and concerns. He was obstructive of scrutiny, and often failed to answer questions put to him.

228. The characterisation of the regulators' and GAD response to Ranson is very much a matter of impression. It has been represented to me that response reflected the civil and measured tones of official correspondence, and that in fact there was continued and sustained challenge of Ranson. That is not my impression. There was challenge, but it was ineffective. Unsatisfactory answers were accepted without follow-up. Lines of inquiry were abandoned or postponed in the face of resistance.

Prudential And Conduct Of Business Regulation

229. The two regulatory authorities failed sufficiently to consider the scope of their respective responsibilities and to ensure that adequate provision was made by them respectively to allocate the total burden of supervision so as to meet total need. This was reflected in the failure to make any provision for the scrutiny of post-contract material, either as it affected the renewal and supplement of existing contracts, or as it was reflected (or not) in the valuation of contractual liabilities and the assessment of PRE. Not only did they fail individually to deal with such matters, but they also failed to institute and maintain a system of communication sufficient to ensure that all relevant material was available in their respective areas of interest. Specifically in relation to the Society's business, there was a failure to consider the implications of the predominant policy type: recurrent single premiums.

230. In respect of that business there was no valid distinction between the initial contract and the renewal of the contract by succeeding contributions. In terms of conduct of business regulation, each transaction was a relevant transaction and, in the case of prudential supervision, repeat contributions were not a contractual right of the Society, and should not have been treated as such for either regulatory purpose. Regardless of the merits of restricting conduct of business regulation to the point of sale, it was not valid for either regulator to regard further contributions as adequately covered by the requirements imposed in respect of the original sale.

231. A practical example of the consequences of the lack of co-ordination was the failure properly to address PRE in the autumn of 1999.

Decision not to Close or Restrict Sales or Advertising

232. Following the House of Lords' decision, when considering whether the Society should close, regulators were faced with competing interests. It is a legitimate and

necessary part of prudential regulation that the interests of existing and potential policyholders may need to be balanced, and I do not find fault with the regulators for arriving at the conclusion that they did, although I am concerned that FSA and GAD did not have sufficient independent knowledge and understanding of the Society's business to justify their confidence that a sale could be achieved. Nor do I consider that the decision reflected a conflict between prudential and conduct of business objectives, a suggestion that is based on a misunderstanding of the nature of prudential regulation.

233. However, the regulators proceeded on an assumption that if anyone were disadvantaged by a decision not to close the Society, compensation would be available. No legal assurance was sought that this would be so, and there was no examination of the legal issues involved. There was no recognition recorded that if compensation claims were sustained, those claims would be at the expense of the with profits fund, nor any attempt to quantify the risks to which potential policyholders were exposed relative to the benefit claimed by management for continuing to trade. No consideration was given to measures that might have mitigated the potential for subsequent claims of misrepresentation. The Society was permitted to continue its advertising, and so those taking new or further policies with the Society did so by invitation and not as mere volunteers without the risks of doing so being made known to them.

234. In the course of maxwellisation it has been represented that criticism of regulators' actions and decisions relating to product sales fails to give adequate weight to FSA's power to require a scheme under which affected policyholders would be compensated without need for litigation. This misses the point that steps could have been taken to protect late joiners in advance. The Society required them to disclaim any potential benefit from the sale of the business. A reasonable counterpart would have been to have protected them from loss by allowing an option to transfer out without penalty in the event of the sale process failing. Thought for the cohort at risk would have identified the need for protection rather than ex post facto compensation.

Annuity Guarantees and the Differential Terminal Bonus Policy

235. The Society's view of their annuity guarantee obligations was intimated to regulators and GAD in general terms in November 1993. The record of that meeting should have informed the scrutiny process thereafter. I do not accept GAD's representations that the record of that meeting did not give a sufficiently clear indication of the Society's intentions to warrant immediate follow-up. The terms in which it was recorded in the note of the meeting make clear that it was intended that guarantees were to be met through some form of trade-off or post hoc charging. At the very least clarification should have been sought. Failure to follow up on the information provided immediately, and more particularly in the context of the scrutiny of the 1993 returns, constituted a serious lapse in regulation. GAD's observation that the record of the meeting suggests that the Society materially under-stated their exposure only makes this failure more pertinent. Any reasonably diligent enquiry would have elicited information about the December 1993 Board resolution, and the terms of the bonus declaration of February 1994, that would have informed GAD and regulators of the problem before it became a disaster for the Society and its policyholders. The regulators' observations to the inquiry, suggesting that annuity guarantees were a conduct of business issue, might explain, though not justify, DTI indifference to the issue. But GAD should still have identified the point.

236. GAD also failed to respond to disclosures of the differential terminal bonus policy in the 1993 and later returns. Failure to make relevant enquiries meant that the regulators and GAD also failed to identify and question the adequacy of disclosure of the policy in statements to policyholders in and after 1995. I note GAD's representations that the disclosures in the returns were convoluted and unclear, and hidden away in many pages of bonus description, and that the service

level agreement did not provide for GAD proactively to pursue bonus policy issues with companies. I do not find them persuasive. 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 with the Society.

Reliance on external assessments

237. DTI paid excessive attention to external ratings, such as by Standard & Poor's, without enquiring into the basis of the assessment, the relevance of the tests applied, and the relevance of the results to the scrutiny of the Society's position.

238. Senior regulatory officers in responding to the maxwellisation process have protested that this assessment is "simply incorrect". They have stated that at the beginning of the 1990s DTI and GAD paid no attention to the assessments of rating agents, in a culture that was relatively inward-looking. In the 1990s staff were encouraged to look to external sources. The representations stated:

> "Some staff members may have implied a greater reliance on these ratings in their notes but this was neither policy nor widespread. A significant divergence between in-house assessments and rating agency assessments, or a sharp shift in rating agency assessments, provided a trigger for debate and discussion from time to time. But in general, the view taken was that the ratings agency assessments were relatively superficial; and that changes in rating tended to occur relatively late in the day, and later than shifts in DTI/GAD's own assessments of companies. The existence of rating agency assessments was of course of some use from time to time in dealing with enquiries about the financial strength of life insurers, since the DTI had a clear policy that in-house assessments were not to be revealed; this could conceivably be the cause of the Inquiry's misapprehension."

In my view there is ample evidence to support my original assessment that undue reliance was placed on these sources.

Growth and success.

239. GAD erred in equating the Society's growth in premium income with success. In their representations, GAD have said that it was appropriate for the scrutiny reports to have mentioned new business growth as a positive factor, but they deny that they equated it with success. They say that rapid growth of recurrent business would have rung alarm bells because of new business strain on a company's free assets, but that this was not the case with the Society' because its business was predominantly RSP. This underscores the failure to comprehend the way in which new business costs were treated by the Society, as well as the significance of the Society's famously low free asset ratio. The notion that there was no new business strain with RSP business is misconceived, and the quasi-zillmer adjustment demonstrates the significance of the issue for the Society.

Key Findings

240. The following may be regarded as the key conclusions arising from this report:

(1) The executive management of the Society resolved as early as 1983 on the approach to meeting the cost of annuity guarantees from terminal bonus that became the differential terminal bonus policy and formed the basis for the *Hyman* litigation. This decision was not communicated to the Board until 1993, and not to policyholders in any form until 1995.

(2) This policy was material to the decision not to start a new bonus series in 1988 and to market the new personal pensions as essentially a continuation of the earlier retirement annuity business. This exposed those joining the fund to the potential cost of the guarantees and was not adequately disclosed. The Board appear to have taken the decision not to start a new bonus series without adequate consideration of the relevant factors.

(3) The Society adopted a policy whereby unguaranteed terminal or final bonus became an increasing proportion of total allocations. This was in line with industry trends, but had the intended effect of reducing over time the share of benefits which required to be reserved for or recognised as liabilities in the Society's statutory accounts and regulatory returns.

(4) As a consequence of this shift towards terminal bonus, and in the absence of any coherent or consistently applied smoothing policy, the Society began to over-allocate from the late 1980s onwards, with the effect that the realistic financial position (as reported regularly on internal systems and therefore known to the executive management) was progressively weakened, and policy claims progressively withdrew funds in excess of prudently calculated policy values. By the end of 2000, the position reached could only be dealt with by radical re-alignment of policy values, as happened in July 2001.

(5) The Society's solvency position was bolstered over the period by the consistent (and frequently acknowledged) adoption of the weakest valuation basis, plus a series of particular valuation practices of dubious actuarial merit (the interest rate differential, financial reinsurance and the quasi-zillmer adjustment) and other financial adjustments and supports (increasing reliance on future profits and subordinated debt) that sought to anticipate future returns.

(6) The Board had insufficient knowledge and skills to provide an effective challenge to the executive in critical areas, in particular in relation to product design and liability valuation. Internal systems were ineffective in ensuring that the Board could form an independent view of the financial position of the Society, and the Board accepted a position whereby the provision of financial and product information was too fragmented for a clear picture to be formed.

(7) Regulation was based on an over-reliance on the appointed actuary, who in the case of the Society was also the chief executive over the critical period from 1991 to 1997, despite a recognition of the potential for conflict of interest inherent in this position.

(8) The regulatory returns and measures of solvency applied by the regulators did not keep pace with developments in the industry, in particular the trend towards unguaranteed and unreserved for terminal bonus. Thus regulatory solvency became an increasingly irrelevant measure of the realistic financial position of the Society.

(9) The significance of policyholders' reasonable expectations under the legislation was understood by the regulators, who had also developed over time a good appreciation of the factors involved. There was, however, no consistent or persistent attempt to establish how PRE should affect the acknowledged liabilities of the Society.

(10) The regulators also failed to give sufficient consideration to the fact that a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of future surplus. In the case of the reinsurance agreement, it is not clear on what basis the Society was permitted to take the credit against its potential annuity guarantee liability that it did.

(11) There was a general failure on the part of the regulators and GAD to follow up issues that arose in the course of their regulation of the Society, and to mount effective challenge of the management.

It is also significant to note that at all material times the appointed actuary of the Society was able to claim that the Society's valuation practices were consistent with applicable professional standards, and that the auditors are able to claim that the discharge of their duties met all applicable auditing standards.

CHAPTER 20: LESSONS FOR THE FUTURE

1. The single most important contributor to the situation at the Equitable Life as at the inquiry reference date, in my view, was undoubtedly the underlying financial weakness of the with-profits fund that had developed from the late 1980s onwards. As I have sought to make clear, this weakness was not simply a matter of some slippage between two large aggregate numbers, the incidental result of smoothing practice that dipped too far below a prescribed norm. It was the accumulation of a large number of individual differentials, realised and hidden within the continuing fund, between policy values, as recognised by management and expressed to members, and what might otherwise be seen as a fair share of the underlying assets reflecting the duration of each policy and the returns earned by the fund.

2. By the reference date, a large proportion, certainly more than half, of the excess allocated to individual policy values had been crystallised through maturities and other claims. Outgoing policyholders benefited disproportionately from over-payment, to the direct detriment of the continuing and new members of the fund, which continued with a reduced capital base. Despite the attempt to restore equilibrium in July 2001 on a fund basis, the inherited pattern of differentials as among different generations of policyholders persisted, albeit with lower values, after the reference date. In seeking to learn the lessons for the future, this seems to be to be the crucial starting point.

3. In drawing lessons, I have had regard to the work that FSA has been doing to update its rulebook and to learn the lessons from the Equitable experience. As will be reflected below, this work has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that. (It might have been a matter of some concern if it had not.) I have included some notes on the FSA's work in Appendix E.

4. I do not wish to comment on the FSA proposals in detail. These are subject to a process of consultation with which I have no desire to interfere. In the context of this report, the most relevant observations are:

(a) that there has been active consideration of many of the problems reflected in the account of Equitable's history, and proposals have been tabled that, after due consultation and implementation, could provide the tools necessary for future regulatory systems that would capture the information and issues at stages at which effective action was possible;

But:

(b) it is worth emphasising at the outset that however highly specified the tools might be, and however well-adapted to the needs of practical regulation, they will be useless unless the personnel charged with their use have the skills and experience necessary for their effective application.

However, there are some particular issues arising from the FSA proposals that I should like to address as I go through the lessons.

Bonus Distribution and Smoothing

5. The gap between the representation of the Society's financial position in its published financial statements, for regulatory and Companies Act purposes, and its realistic financial position arose in large part from the absence of a coherent and consistently applied policy on bonus distribution and smoothing. The Society's frequently acclaimed principle of full distribution combined with its claim to ensure

a smoothed return seem to have acted as an effective shield against a proper consideration by the regulators of Equitable's approach to bonus distribution.

6. FSA's proposals for life offices to provide statements of their principles and practices of financial management (PPFMs) are an important step forward in this respect, as are the FSA's latest proposals on treating with-profits policyholders fairly[1], which were published shortly before this report was finalised. Under these latter proposals there are to be specific rules and guidance on:

i. Target ranges for payouts and smoothing;

ii. Definition of 'asset share' for these purposes;

iii. The distribution of surplus; and

iv. Surrender values (including market value adjustments/reductions).

I consider that it is essential for the regulators to have a clear statement of a life office's approach to the financial management of its with-profits fund, and its approach to smoothing returns to policyholders in particular. The absence of such a statement was without doubt a serious impediment to effective regulation of Equitable, one that should not have been tolerated as it was. It is also clearly desirable that some such statement is available to the general public, policyholders and their advisers. I therefore welcome FSA's proposals to require offices to be explicit about the parameters within which their discretion over bonuses will normally be exercised, and the consideration that is being given to supporting this with specific rules and guidance.

7. I also agree that, within any rules or guidelines, some leeway must be recognised to enable offices to deal with particular circumstances that fall outwith the realistic range used for establishing those parameters, and to enable firms, within reasonable bounds, to manage a fund back from an under-funded position.

Heterogeneity of With-Profits Funds

8. Looking back at the development of the Society's products over the past half-century, it seems to me inevitable that the homogeneity of any unitary with-profits fund is bound to be undermined as a life office reacts to changing market conditions and changing product demands. There is no obvious a priori basis for determining when existing funds should be closed and new funds opened. There is always scope for including different bonus classes within a single fund, particularly where one can identify and quantify differences in benefits on an acceptable basis among funds that otherwise share common risks. As indicated in the body of the report, it seems to me that it would have been open to the Society to recognise variations in guarantees as among different classes of business as a basis for differentiating bonus policies in and after 1988. The circumstances in which a new class of business gives rise to differences that cannot be accommodated within an undifferentiated fund becomes a matter of circumstances that can only be identified when it occurs: it will be recognised rather than anticipated.

9. There are other problems. In a widely mixed fund, management policies developed at one stage in the fund's progress may become wholly inappropriate at another. An amalgamation of interests that seemed acceptable at one stage, may become difficult to maintain in the light of emerging circumstances. Inter-generational and inter-cohort adjustments may be required that become difficult to explain to those who appear to be adversely affected. Historically 'discretion' has been relied on as authority to make whatever adjustments the actuary and his board have thought appropriate in the circumstances at the time. But in the nature of things, a discretion that is essentially reactive to circumstances that would have been avoided if they had been foreseen is incapable of prior definition. In an era that must be marked by more open definition of management policies and practices, the boards of life offices may have to become more circumspect in seeking to

[1] Treating With-Profits Policyholders Fairly, FSA consultation document CP 207, 5 December 2003.

accommodate business with potential for conflict of interest within a single with-profits fund. Regulators, obliged to consider whether policyholders are treated fairly, having regard among other things to their reasonable expectations, may have to question the management of mixed funds as the business mix changes.

10. Certainly the Society's single with-profits fund incorporated a very wide range of different types of business: traditional life products, pensions products and pure investment products, domestic and overseas business, and even within policies of the same class there were often widely different types or levels of guarantee. The Society's bonus declaration resolutions ran to many pages of detailed allocations varying in kind and value. The system depended on the exercise of the management's wide undefined discretion and resulted in impenetrable complexity.

Implications for PPFMs

11. This underscores the concern, recognised by FSA in their latest consultation paper[2], that the twin purposes of PPFMs, to inform the regulator and to inform the public, imply rather different levels of disclosure. While it is right that FSA should seek to ensure some definition of the scope of the discretion to write different classes of business within a single with-profits fund, it suggests PPFMs may need to be relatively complex documents if they are to address adequately the totality of some firms' with-profits business at the level necessary to inform a critical appraisal by the regulators[3]. I therefore agree that it is essential that there should be a second, less detailed tier of material that is carefully crafted in order to create the necessary public transparency. The precise form, and the question of whether or not that should replace existing documents, such as the with-profits guide, I must leave to FSA and those responding to their consultations.

12. A more specific concern arises from the inter-generational transfer point made in chapter 6 and reiterated in the last chapter. The Society managed its with-profits fund in such a way that there was no adequate mechanism for restoring an acceptable balance between policy values and 'asset shares' (within the bounds of established smoothing policy), while also dealing fairly with the legitimate expectations of different generations of policyholders. Thus the fund could be restored to balance, but only by a disproportionate cut in the policy values for more recent policies which had accrued lower levels of bonus than longer-duration policies. It is unclear from the FSA's documents published so far how it is intended to address the position that existed at Equitable. The scope for inter-generational unfairness needs to be recognised. It should be clearly established how bonuses are allocated, and by what mechanisms any imbalances between policy values and asset shares, and between the guaranteed benefits of different generations of policyholder, can be corrected. Whether this should be part of a firm's PPFM may require further consideration.

Development of New Products and Splitting With-Profits Funds

13. The decision taken by Equitable management around 1983 that in the event of a sustained period of low interest rates the cost of the annuity guarantees could be met from within terminal bonus depended on the extent and exercise of the Society's discretion over terminal bonus. The differential terminal bonus policy subsequently adopted was, of course, ruled to be outwith this discretion in the *Hyman* case. However, the differential terminal bonus policy would not have been needed if the Society had adopted a separate bonus series for the new personal pensions business from 1988. The decision to maintain a single series, and to market the new policies as effectively a continuation of the old RAPs, reflected the intended policy. And, as I have already commented, if the Board were genuinely unaware of the management's intended approach to annuity guarantees, then they do not appear to have

[2] CP 207, chapter 6.

[3] If proposals for the preparation of realistic accounts were to develop along the lines proposed by Dullaway and Neddleman in their paper to the Institute of Actuaries on 24 November 2003, neither the PPFM nor the financial statements reflecting the proposals would be intelligible generally.

adequately considered the implications of the guarantees or their options at that time.

14. As I have noted above, there is no a priori basis for determining when a fund should or should not be split. Nor should the regulator become too involved in the process of developing new products. But there is a need for greater vigilance over the introduction of new products and the development of existing products. In the first instance this vigilance must be applied by management, and I note that in CP 207 FSA have proposed new guidance to with-profits firms concerning their approach to the volume of new business, and a new rule that:

> "...firms must not write new business unless, in the reasonable opinion of the governing body, this is on terms that are unlikely to have a material adverse effect on the interests of existing with-profits policyholders".

15. I think this is a reasonable test to ask firms to apply. But it needs to be supported by effective measures to ensure that boards have access to, and an understanding of, their existing liabilities and the implications of new products. I will return to this below. And FSA must ensure that the reporting requirements for firms are designed to pick up significant changes in the balance of interests of new and existing policyholders within the same fund.

16. I assume that the same test will be applied to proposals to issue subordinated debt. It is important, especially with mutual offices like Equitable, that such proposals are given rigorous scrutiny in light of the particular constitution of the office involved. The emphasis FSA are now placing on understanding the commercial reasoning for 'financial engineering' should also be helpful here. Despite the claims of management that the purpose of the subordinated debt was to increase investment freedom, the sums involved suggest that it made no real commercial sense except as an immediate measure to ease regulatory controls.

Amounts payable under with-profits policies

17. There was a fundamental lack of transparency in Equitable's management of policy payouts from the with-profits fund. If the proposals discussed in chapter 4 of CP 207 had been in force, Equitable's practices would have been exposed to critical appraisal. The suggested requirement that over the longer term average payouts would reflect a broadly neutral balance of smoothing would not have been met at any time from 1987 onwards.

18. However, the proposals lack definition and as currently framed appear to leave unanswered many of the issues that would inevitably have arisen in the Society's case. The Society would have had no quarrel with the definition of unsmoothed asset share as the value derived from investing the policyholder's premiums[4]. It would, on the evidence, probably have defined the smoothing cycle prospectively as three to five years. There would have been difficulty in identifying target ranges for payouts and smoothing. But the more substantial issue would have related to the regulatory response to the inevitable failure of the Society to meet its targets. For example, by 1989, and despite the excellent returns of that year, the Society's payouts were made on the basis of policy values that had exceeded available with-profits assets since at least 1987. In 1990 payouts ignored the dramatic equity losses sustained, and continued to reflect accrued terminal bonus allocations that had ceased to be covered by the investment gains on which they had been computed. Equitable's methodology simply did not fit the model by reference to which the FSA proposals have been developed.

19. FSA comment that their proposals are "expressed in terms of an objective rather than an obligation"[5], and in general it is understandable that such an approach should have been adopted. But the Equitable experience suggests that there may be circumstances in which nothing other than an enforceable obligation

[4] CP 207, paragraph 3.6.

[5] CP 207, paragraph 4.14.

will empower effective regulatory action. Equitable's methodology may have been uncommon, even unique. But it was widely advertised, and was allowed to continue without disciplinary action by the relevant actuarial bodies. It must be assumed that it was within the scope of acceptable actuarial practice in the profession's view. If so, it could happen again. The present proposals do not equip the regulator to take effective action in such circumstances.

Free Estates

20. I note that FSA's proposed rules on the distribution of surplus seek to address the risk that policyholders may be underpaid over time (building up unnecessary reserves), as well as the risk that they might be overpaid (weakening the fund). While the risk of "excess inherited estates" seems remote from the lessons of this report, based on Equitable's more recent experience, this does highlight the essential question of what constitutes an adequate estate. I welcome the recognition that inter-generational issues should be of significance to the regulator, but FSA must approach this question with caution. It should be clear from the Equitable experience that the need for an estate must reflect the volume, the range and the nature of the business conducted by the life office, and FSA's proposals for realistic accounting (see below), risk-based regulation and individual capital adequacy standards should provide a better means for assessing this than has been available in the past.

21. However, it is also clear to me that the regulator has in the past approached the question of PRE with a strong emphasis on the problem of orphan estates. I would be concerned if that led to a bias against the prudent holding of sufficient risk capital to ensure the office's ability to withstand market and other shocks. This area has been bedevilled in the past by the use of emotive terminology. It will be necessary to provide clear definitions of the several elements of value involved and to require specification of the levels of discretion claimed in respect of each. For example, in the context of reattribution, FSA comment that normally a significant part of the estate would continue to be needed as capital to support the business and neither the policyholders nor the shareholders of the firm would have access to that part of the firm's funds[6]. It seems to me to be clear that one would require specification of all prior calls on the fund, principally liabilities present and future, and operational capital requirements at all times, and not only when a reattribution was in contemplation.

Accounting for With-Profits

22. At no point during the inquiry reference period were Equitable required to account for the financial position of the with-profits fund in terms that would have disclosed a realistic position to policyholders or the regulators. The requirements for disclosure through the Companies Act accounts and the regulatory returns did not require adequate accounting for, or even disclosure of, policyholders' accrued expectations of terminal bonus. Management, however, were aware of the realistic value that might be attached to such expectations, and routinely prepared valuations of the fund on a basis that did recognise this value.

23. Other problems with the Society's published financial statements were the absence of any reconciliation between the accounts and the regulatory returns (or for that matter with the office valuation), valuation movements between accounting dates were not disclosed in an intelligible and informative way, and there were no notes disclosing risks to which the Society was exposed by its approach to liabilities valuation. Furthermore, various financial adjustments were employed, with regulatory sanction, which further removed the stated position from reality. In short, policyholders and the general public were not adequately informed of the Society's

[6] CP 207, paragraph 5.6

financial position, and the regulator too lacked essential information upon which to form a reasonable view of the Society's realistic financial position going forward.

24. Assuming that one can imagine a future in which with-profits operates in an open way, with published PPFMs constantly monitored and deviations identified and corrected, with smoothing always kept within bounds, and with every policyholder treated fairly, there would remain a need to account for the stewardship of management in published financial statements. The Equitable experience has demonstrated that there has been scope for too many different presentations of financial results, each purporting to present, internally or publicly, a picture of the Society's operations in forms that were difficult if not impossible to reconcile.

25. So long as there is a regulatory solvency test prescribed under European Directives, there will be a need for financial statements that meet the regulatory requirements developed for that purpose. Under the historic regime these statements have been impenetrably mysterious, over-complex, over-wordy, and detailed to the point that overall substantial effect has been buried. The Society's returns were so convoluted that material information escaped notice of regulators and their advisers in GAD. There is a need for regulatory accounts that, however detailed their backing schedules might be, present the results in clear and readily understood form that can be compared with and reconciled with the Companies Act accounts, with differences noted and explained, and information provided as to the reasons giving rise to the differences. Essentially there is a need for an abstract of the regulatory financial statement that can be set against an abstract of the Companies Act accounts and explained.

26. In order that policyholders and members can understand the regulatory picture the objectives of the regulatory accounts need to be specified clearly, positively and negatively. It is important that they should not be presented as providing a measure of the office's overall financial position that cannot be substantiated. Claims that the accounts demonstrated 'solvency', for example, were meaningless without a clear and simple explanation that solvency for this purpose had a highly structured meaning that might have had no bearing on the ability of the insurer to deliver at maturity benefits of the level that might have appeared in illustrations given to the policyholder.

Realistic Accounting

27. The main deficiency in current regulatory accounting has been that the accounts did not reflect the realistic position of the office either in their basic terms, or after financial adjustment for a range of values of a highly technical character that divorced the accounts from the reality of the business. Nor have the Companies Act accounts been much better. They have omitted from technical provisions the value of accrued terminal bonus, and required no other recognition of value reflecting that item. Specifically, where future terminal bonus has been recognised in or related to the fund for future appropriation, there has been no requirement to disclose the office's projection of value of terminal bonus or the extent to which the fund for future appropriation covers that value. Irrespective of how one would quantify accrued terminal bonus, not to recognise it at all is a primary source of the problem in Equitable's case. The Society did not recognise any need to provide for the value, whatever it might have been, and did not allocate any part of its fund for future appropriations to it. Had the Society made clear at any time during the 1990s that there was no accounting recognition of accrued terminal bonus, and that the amount intimated to policyholders was not covered by available assets, the impact on its public image would have been huge.

28. There are other associated problems. The current approach of focusing on the fund position at the accounting date tends to conceal the movements in value that have occurred over the accounting period. Equitable's position in 1990 illustrates the point. The net addition to the fund during the year was £530m. Declared bonus contributed £270m. But there had been premium income alone of over £1.3 billion. Claims had amounted to £660m. On the figures disclosed there was no means of

identifying the movements over the year that explained the relatively low increase in fund value. The president's statement made the bald comment that the liability valuation had been reduced on sound actuarial principles. But that did not provide the basis for analysis.

29. Worse still, there was no information linking the reported annual position and movements in fund value to the position intimated to members in benefits notices. The typical statement issued in February 1991 showed a guaranteed fund value brought forward from the previous year, new investments in the year, guaranteed interest and declared bonus, a new guaranteed fund value at the relevant reference date, and a final bonus addition. There was no adjustment to the guaranteed fund values to reflect the change in valuation assumptions reflected in the accounts. (representing the difference between full or face value versus discounted liabilities) What the Society did, in relation to claims, reflected the position intimated to policyholders in their notices. The accounts did not intimate that despite the actuarial adjustments made at fund level the Society intended to go on paying on claims as if the losses reflected in the reduction in liability values had not occurred.

30. There is a need for accounting standards for the disclosure of movements in value related to actuarial assumptions, for the relationship between accounting information and the quantification of claims payouts generally, and for the publication of accrued terminal bonus values together with a reconciliation between that value and the general reserves available to cover it. The industry cannot be left to its own devices. Without specification of standards, there would continue to be wide scope for differences of opinion that left financial statements substantially meaningless in absolute terms, and difficult to compare with other companies' accounts.

31. I welcome the work that has been undertaken by FSA to develop the role of realistic accounting in the regulatory sphere. This is of particular importance at present, given the absence of adequate accounting standards. The latest SORP, long in gestation, has gone some way towards providing solutions to some of the problems arising from the lack of binding standards. But until there are standards for all financial statements, FSA will have to take the lead in prescribing requirements. The existing limitation of regulatory reporting requirements, in effect, to guaranteed benefits has meant that the reality of with-profits business and the regulatory measure have progressively diverged over a very extended period. This failure to keep the focus up-to-date has been compounded over the years by limitations of the standard principles applied to the valuation of life office liabilities. While the net premium basis applied for regulatory purposes was not well adapted for a firm with significant RSP business, the alternative gross premium or bonus reserve method, to which the Society primarily adhered, was highly subjective.

32. The introduction of FSA's 'twin peaks' approach, under which life offices will be required to set their capital requirements at the higher of the levels brought out on the regulatory solvency and realistic bases, may have to serve as the specification of industry standards for some time. It must be sufficiently robust to fulfil that role.

Financial Adjustments

33. In Part III of this report in particular I have discussed various measures used by the Society to bolster its financial position as measured by the regulator. In this regard I welcome the proposals of the FSA to require firms generally to value guarantees and options at market value, or by means of market-based stochastic techniques. I also welcome the move, recommended in the Baird report, to exercise greater discretion in the use of future profits implicit items. In due course, the changes to the directives will eliminate their use altogether, but in the meantime it is important that the supporting evidence required under the domestic regulations is interpreted as referring to evidence that management expect the returns to emerge from written business on the basis of reasonable assumptions about the future position of the fund.

34. As this inquiry has progressed, I have become increasingly conscious of an aspect of actuarial practice that underlies many of the accounting issues that have arisen: the focus on the present position of the with-profits fund at the given reference date. I have mentioned above one consequence: a disregard of the historical development of the current position, facilitating what I have referred to elsewhere as sweeping the actuarial footprints from the snow. The approach to the judgmental aspects of the future profits item, at least in Equitable's case, tended similarly to focus on the current position, with inadequate attention to anticipated trading conditions looking forward. The issue was treated as relating solely to the existence of current valuation margins, without consideration of the factors that might have a bearing on whether those margins would be likely to be realised as profit in the foreseeable circumstances.

35. The broadening of the discussion of guarantees and options, and of the discretionary element in dealing with future profits are steps that are consistent with the more general move to use realistic accounting and adoption of a more risk-based approach to regulation. These moves should also be helpful in addressing the lessons arising from the financial reinsurance agreement. There is no scope for absolutes here, as FSA recognise, but particular arrangements must be subjected to effective critical appraisal. One relatively simple test might be to compare the claimed value of the protection with its commercial cost. Reinsurance is a commercial business, and providing something of value for nothing or for a very small consideration will be rare. Where a firm claims to have obtained valuable cover for a relatively small premium, the regulator should be wary.

36. I would also draw attention to the claims of particular regulators that they understood the nature of the agreement, that it was essentially a financing instrument that did not purport to transfer risk. Despite that, the treaty was used to offset real liabilities on the regulatory balance sheet. As I have observed earlier, I cannot reconcile that treatment with the requirements of the regulations. The integration of the actuarial and more general regulatory functions under FSA has, in my view, been a necessary and valuable development. Bringing together the various skills involved could only be of advantage as compared with the previous fragmented regime. But I would encourage further development of the multi-disciplinary approach. Consideration of the accounting and legal issues that inevitably arise in the regulatory process should be fully integrated into the primary process. There is a tendency to refer issues for legal advice once they have been focussed in more general discussion. One has the impression that actuaries have at times acted as if they were fully qualified in accountancy, law and other disciplines so as to need no outside support[7]. Whether that is tolerable in a particular company is a matter for that body. It cannot be acceptable in regulation.

37. I particularly welcome FSA's commitment to ensure an enhanced level of testing and assessment for financial engineering generally, including a greater emphasis on the need to address the whole transaction (side letters and all), plus better training for supervisors and more use of specialist expertise, provided that it is recognised that the range of specialist advice that is appropriate may be wide

Common Accounting Base

38. In the longer term it should be an objective to move in due course to use of a common accounting base for all financial statements. Completely independent systems for Companies Act and regulatory financial statements is an unnecessary and confusing complication in what is inherently a difficult area of accounting. Superficially, there is an obvious solution, to base regulatory returns on the Companies Act accounts with a statement of differences linking the two statements.

[7] One senior actuary told me that he had written contracts in which he incorporated a statement that neither the contract document nor the articles of association of the company set out the whole terms of the contract. It was not immediately obvious to him that he had demonstrated his lack of capacity for the task.

Using the audited accounts as a base would underline directors' responsibilities for the whole financial statements, and with the support of the auditors' report and appropriate actuarial certification of liabilities, enable regulators to concentrate on those aspects of the total statement that had particular relevance. This would make FSA's risk-based regulation more effective. There may be difficulties with this approach, as with any other, and it is necessary to be cautious in proposing solutions that rely on the philosopher's stone. But some such solution would appear to provide a way forward.

39. However, at present the fundamental problem with the statutory accounts of any life office is that the accounting professions have failed to develop acceptable standards for the preparation and presentation of accounts of long-term business that require realistic accounting on a consistent basis, with disclosure of variations in practice reconciling year-on-year results. Proposals, exposure drafts, and similar consultation exercises are not a substitute for normative standards. The continuing failure to produce acceptable standards and secure their implementation is a failure in a professional duty owed to the public. It is a failure in duty to shareholders in proprietary companies. It is a failure in duty to policyholders in proprietary and mutual companies. Those with the responsibility to produce appropriate standards must have it impressed on them that what is required are practical standards of general application that will provide consumers of accounting information and their advisers with ready means of assessing the financial positions of the providers of financial products. A search for perfection in this area will fail. To await agreement among the wide range of interests affected will involve interminable delay.

40. In the case of long-term insurance products, developments focused exclusively on the interests of shareholders will not suffice. Policyholders' interests must be included. Policyholders are investors in offices' products. Their interests, in financial terms, usually exceed those of shareholders by factors of about 9:1. It would be totally unacceptable if standards should be developed that did not focus on the interests of policyholders.

41. If the professions will not or cannot provide necessary standards, domestically or internationally, and FSA's contribution to domestic accounting requirements remains, of necessity, an aspect of regulatory practice, the alternatives would appear to be to accept further stagnation, or for the Government to consider establishing a statutory body with power to impose standards within the UK. This would be a controversial and difficult step. But literally millions of savers are involved, and their interests should prevail over the entrenched privileges of the professions and the interests of the providers. There is a view that with-profits cannot survive without mystery. But that cannot continue to provide an excuse for delay in the open provision of relevant financial information.

Keeping Abreast of the Market

42. More generally, the failure to recognise accrued terminal bonus highlights the need to ensure that regulatory systems are at all times adapted to current practices in the industry. It has been a major theme of this report that prudential regulation remained focused on contractual or guaranteed liabilities, while the industry progressively developed practices that took advantage of the freedom from risk of regulatory intervention in the management of non-guaranteed benefits. There was real dislocation of regulation from the reality of industry practice.

43. It is inevitable that industry practices and product design will change over time, and also that regulated entities may adapt their practices specifically to exploit the characteristics of the regulatory system. That is an inherent, and desirable, aspect of an active market, and the regulators should be careful not to become too prescriptive. But the regulators must keep abreast of market developments, and consider the requirements of the regulatory accounting system against market

trends, and should where necessary require firms to inform policyholders and potential policyholders of the regulatory implications of their practices.

44. The 2000 Act has provided the Treasury and FSA with broadly defined powers to be exercised in light of specified regulatory objectives. This suggests a clear intent on the part of Parliament that the focus for regulation, and the tools employed, should develop with the market. It will not be adequate in future to claim that adhering to a particular practice reflects the will of Ministers long since left office. Constant review will be required to ensure that reporting requirements continue to focus on areas of current relevance to the exercise of regulatory powers.

Audit

45. Audit depends on the adoption of accounting standards. Without the latter there is no point of reference for the audit opinion. However, the issue that arises from Equitable's case, so far as the remit covered this issue, is the inter-action of audit and actuarial verification of underlying assumptions in the liabilities valuation. In the case of the Society, the audit team were aware of relationships between assets on the one hand, and liabilities and future payments of terminal bonus reflected in the bonus notices to policyholders on the other. But there was no need to advertise the differences because of the view taken that final bonus was not 'guaranteed'. This left the Companies Act accounts less than informative of the real position of the Society as it affected not just policyholders as a whole, but different generations and different cohorts of policyholders.

46. The omission from the scope of auditors' responsibilities, over considerable periods, of a duty to report on the actuarial assumptions on which the liabilities themselves were determined, as distinct from taking steps to satisfy themselves that they could rely on the reporting actuary, was a weakness in the system that required and still requires to be addressed. Evidence of this weakness can be seen in the Society's failure to value its primary obligations with respect to its annuity guarantees and options appropriately.

47. The basic problem here is that an audit of part of a balance sheet cannot provide comfort in relation to the state of affairs of the company in question generally. The exclusion of the auditor from responsibility for liability valuation in the early 1970s should never have been contemplated, in my view, and it should not be allowed to continue. The contemporary debate reflected a degree of arrogant professional discrimination against the accounting profession, especially on the part of GAD, that was and should have been seen to have been, wholly unacceptable. In the result, one had an audit that was less than comprehensive. Of its nature a 'balance' sheet only makes sense, even assuming it is aimed at presenting the realistic position of the entity, if the policies and practices adopted in computing and expressing assets and liabilities are compatible. Allowing one professional, the auditor, to express a view about the assets and peripheral liabilities, but excluding him from the long-term liabilities, while allowing another professional, the actuary, independently to certify the liabilities is like commissioning the two legs of a pair of trousers from separate tailors.

48. I note that FSA have proposed a requirement for the auditor to obtain a report from an independent actuary. That is a material improvement in the position, and it is to be welcomed. It should ensure that the audit opinion is supported, in relation to the technical provisions of the long-term business, by a qualified expert's opinion on the actuarial issues that arise from the valuation. In that respect, the audit of long-term business would be in line with other sectors where the auditor is necessarily dependent on third party professional opinion.

49. The question, however, is whether one should go further. The valuation of a life office's liabilities, and of any additional provisions that might be required for accrued terminal bonus, for example, are so fundamental to any assessment of the company's financial position that, if audit cannot be comprehensive, there is a case

for a direct report to shareholders and policyholders by an actuary, on the face of the accounts and in parallel with the audit report. The report would require to express opinions on the valuation and on the essential assumptions reflected in it similar to those contained in the auditor's report, and the actuary would be responsible for his opinions as the auditor now is for his. Ideally, since the two reports would be complementary, there would be a case for legislation to make provision for a joint opinion of an auditor and an independent actuary, for which they would be jointly and severally liable, that the accounts met the specified standards. That would reflect the reality that it was the cumulative effect of the two reports, and that alone, that provided the necessary support of the financial statement. But I have come to the view that that would be a step too far at this stage, before the more limited proposals have been implemented and tried in practice.

Corporate Governance

50. Arguably the first and most significant failure identified in this report lay at the heart of the Society. The critical responsibilities for valuing liabilities, assessing the liability implications of new products, and identifying and monitoring risk generally were discharged by a discrete part of the organisation that was not subject to effective scrutiny or challenge. The Board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to the Board on, actuarial reports. Equitable's non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive/actuary that they were largely incapable of exercising any influence on the actuarial management of the Society.

51. In the case of proprietary firms, the primary responsibility for the selection of directors and calling the board to account for its direction of the business must continue to rest with the shareholders of the company, whose capital stands at risk in the event of mis-management. However, the position is different for a mutual like Equitable, where it is the policyholders who are the source of the risk capital for the enterprise. This raises particular issues in relation to the constitution of the Society. Under the Society's articles policyholders were effectively powerless, and the Board was a self-perpetuating oligarchy amenable to policyholder pressure only at its discretion. It is impossible in practice for policyholders to initiate by requisition an EGM or otherwise to raise special business. Board appointments are effectively in the hands of the current Board.

52. Since 1994 the regulator has had a responsibility to assess whether life offices are soundly and prudently managed. This clearly implies a holistic assessment of the firm and its board that goes beyond the individual assessment of whether individual directors were 'fit and proper'. This broader responsibility has been carried forward into the new regulatory regime, and is reflected in FSA's proposals for risk-based regulation and individual capital adequacy standards. However, it is important that FSA consider how their powers may be exercised to address the problem of unbalanced or ineffective boards. The approved persons regime under the 2000 Act, like the fit and proper regimes it replaced, is essentially designed to deal with the individual officer rather than the board as a whole. This is a difficult and potentially controversial area, that goes to the heart of the respective responsibilities of the directors and the regulators, but it seems to me essential that the regulators should be confident that where necessary they are able to require changes to the board to address major gaps or imbalances in directors' collective skills or experience.

53. It may be seldom that directors and their representatives will assert as strongly as has been the case during this inquiry that, as generalist non-executive directors, the individuals in question were incapable of addressing independently

such fundamental aspects of the firm's business as actuarial management and liability valuation. But the situation may not be uncommon. Difficult though the exercise may be, there appears to be no alternative means of securing an independent view of the appropriateness of the membership of life offices' boards than the exercise by FSA of powers to refuse approval on grounds that the nominee for appointment would not make a necessary contribution to the sound and prudent management of the office by filling a gap in the range of skills and experience required by the office. In the case of an office like Equitable, it is clear that no other means of ensuring an appropriate range of skills and experience would have been effective.

54. The constitutional position of Equitable may be unusual. Participation in governance by members was impracticable. The articles relied on the current Companies Act provisions, with their requirement to obtain the support of 10% of the voting power to initiate special business, which may be well-enough adapted to organisations with a relatively low membership, but are poorly adapted to any large financial mutual with hundreds of thousands of members and no adequate public register to enable a group of concerned members to requisition business. Other offices, such as Standard Life, now allow a minority by number to requisition business. I see no ready means by which regulators could force the remaining mutuals to adopt articles that facilitated policyholder action, unless it could be brought within the test of 'treating policyholders fairly'. But one way or another, means must be found to give policyholders an effective voice in mutual management. Without that, policyholders' committees and other such devices will not be of substance. It may be that sufficient pressure can be brought through FSA's risk-based approach to regulation to persuade mutual offices to facilitate policyholder participation in governance, but if that cannot be achieved, other means will have to be considered.

55. There would be resistance to direct involvement of regulators in management for understandable reasons. The nominee director has always been a controversial notion. And the regulator would be unlikely to welcome an obligation to participate in management. But it might be acceptable for the regulator to have power to appoint from a panel of experts an adviser to the board of a life office in case of need, with access to all board papers and to the board itself, and with power to report to FSA on management. This would fall short of the formal appointment of an independent reporter. It could be more flexible. And if it failed to produce results FSA's subsequent formal action would be facilitated. A power to report to FSA rather than an obligation would improve the prospects of acceptance of the adviser as a source of support to the board rather than a threat to current management. An occasion for the appointment of such an adviser would be recognition of a risk that the firm might be in danger of failing in its obligation to treat policyholders fairly.

56. The representations I have received, and indeed much of the evidence I have reviewed bearing on the governance of Equitable, point to a need for an authoritative statement of the duties, rights and privileges of directors. In chapter 9 I referred briefly to the work of the Law Commissions, and the Government's Company Law Review and White Paper relating to the nature and extent of directors' duties and responsibilities, including their powers of delegation. If the representation of Equitable's directors were taken as a proper reflection of general views within industry generally, the case for implementation of the recommendations for reform would, I suggest, be overwhelming. It is not necessary to go that far. It is enough that it has been possible for it to be suggested that non-executive directors of a major financial institution should be recognised to have limited responsibilities for the direction of certain aspects of the company's business. On that basis alone there is an obvious need to put in place a statutory framework for the future.

Role of the Actuaries

57. In most cases the existing appointed actuary system has probably performed well, and met the legitimate interests of all concerned. I cannot express any general conclusion. But there must be concern at the reliance that has been placed in the past on an office that could encompass such extremes in terms of experience and authority within life offices. At one end of the spectrum, the system could accommodate an idiosyncratic and autocratic individual, like Roy Ranson, charged with running large with-profits funds without significant control by his colleagues, his board, the auditor or the regulator. At the other end of the spectrum there is the minor technician, wholly subordinate to senior management and a board to which he may have but occasional access, and over which he has little influence.

58. Clearly, every life office must have actuarial staff. Should the existing appointed actuary system continue, it is clear that on no account should it be permitted that the appointed actuary should also be the chief executive. That combination should simply be banned under the approved persons regime. It undermines fundamentally the 'whistle-blowing' obligations of the appointed actuary, and would similarly affect any substitute. And it is also clear that if any external reliance is to be placed on the professional opinion of an actuary, in whatever capacity within a life office, the actuarial profession must be encouraged to impose appropriate discipline. Moves to encourage the profession to take that direction in the past have been abandoned by regulators as 'difficult'. But if the profession does not wish to be judged by the lowest common denominator: (a) it must have a well-developed set of prescribed standards; and (b) it must have a properly developed disciplinary procedural system to confront deviant conduct.

59. So far as the disciplinary structure is concerned, the professional bodies in Scotland and in England have radically overhauled their disciplinary structures and, uniquely, have taken steps to ensure the independence of those engaged in disciplinary work by providing for the selection and nomination of candidates by an independent committee chaired by a lawyer with considerable experience in professional disciplinary matters. But there is one area in which I consider there are further steps that could be taken with advantage.

60. In the past disciplinary procedures have typically been reactive to complaints. I have suggested, and repeat the suggestion for consideration, that that does not meet the need in the case of long-term business. In most professional business there is a clearly defined relationship with an identified client. A solicitor or accountant may have a stock answer to a problem that he provides to a series of clients, as a general practitioner will have preferred prescriptions for the treatment of recurring symptoms. But in each case there is a direct contact, and a context for assessing the appropriateness of the advice. The with-profits actuary to a life office serves a huge constituency. Most members of that constituency will have little or no independent understanding of the characteristics of the product under current rules, and while that will improve in future there will be limits to policyholders' knowledge and understanding of long-term products for some time. Education is not instantaneous. The policyholder, unlike the patient, will have a poor understanding at best of the facts and circumstances that might need attention. Few of Equitable's policyholders would have understood the implications of the differential terminal bonus policy without the help of the action groups. It is not enough for the actuarial profession to await complaints. The people best placed to identify the need for disciplinary intervention are co-professionals. It would improve the public image of the profession if it were seen to accept responsibility for direct intervention where it was thought that the administration of life funds was likely to threaten the legitimate interests of policyholders. I would invite ministers to offer encouragement and support for initiatives that the profession might take in this direction.

61. Whether the existing appointed actuary system should continue, or whether FSA's current proposals for a 'with-profits actuary' offer any greater prospect of

effective discipline on the internal actuarial management of life offices, are matters open to argument. In my view, the precise arrangements are less important than the solution to the problem of independent and effective actuarial 'audit'. Audit procedures that ensured independent verification of the validity of the actuarial assumptions on which the valuation is based, squarely focused on the public interest comprising the interests of shareholders and policyholders, and the duty to treat policyholders fairly, including with regard to PRE (a phrase that, however clumsy, appears to have a place in the new order), and the provision of a realistic balance sheet would go far to reduce the importance of the internal organisation of the actuarial management of the office.

62. If effective audit can be achieved, this will greatly facilitate effective regulation. Without it, the task of the regulator will have to be that much more intrusive into the detailed actuarial affairs of the life offices they seek to regulate.

63. In the course of the report I have commented on what I have found to be deficiencies in the specification of standards of practice. I have commented on the lack of standards relating to managing policyholders' reasonable expectations. That will carry forward into the new regime with respect to the obligation to treat policyholders fairly, including with respect to PRE. I have referred to the failure to promulgate appropriate standards for valuing guarantees. The joint professions have set up a committee to consider the elaboration of standards for future professional practice. They should be encouraged in this task.

Conduct of Business Regulation

64. One of the regulators involved with Equitable referred to the boundary between prudential and conduct of business regulation as more an awkwardness than a lacuna. While that may be a fair comment on how the two branches were intended to operate, in practice the lack of co-ordination of prudential and conduct of business regulation in relation to the Society was unacceptable. The Society's changes of policy forms and of the guarantees provided is a typical area where there was a role for each regulator. The conduct of business team were no doubt interested to ensure that the prospectus met the requirements of the disclosure. There may be questions whether the risks were adequately focused in the Society's literature in any event. But the risks could not have been assessed by the conduct of business regulator without reference to the prudential regulator. Had this happened, it might have focussed attention on the implications of the low free asset ratio for new policyholders.

65. The prudential regulator for his part should have been concerned about the impact of the reduction of guarantees on reserving, given the low level of free reserves Equitable had. But that could not be done without undertaking more routine analysis of the product terms, which was clearly regarded as the province of the conduct of business regulator. And the prudential regulator might have been influenced by learning how hard a sell there was of the newer, more 'technically efficient' products. Each exercise should have been instructed by comparing analyses, ideas and notes.

66. The conduct of business regulators adopted a narrow approach to the 'point of sale' that reflected misunderstanding of the contracts the Society sold. In particular, there seems to have been at best a poor appreciation of the peculiar characteristics of the RSP contract. Conduct of business regulators treated the business as if it were all pre-A day because, in most cases, the original contract was so dated. Since the policyholder had a right, but no obligation, to subscribe further sums, each successive contribution required a fresh transaction, and a fresh assessment of the appropriateness of the contract for the policyholder's need. Again co-ordination with the prudential regulators should have alerted them to the peculiarities of the form and the need to look on each successive year as a new transaction.

67. With the introduction of the single regulator and the reorganisation of responsibilities within the FSA, the resolution of this problem is in hand. It is vital that FSA continue to work towards a more holistic approach to the business of particular firms and groups. To avoid further awkwardness, care of the customer must be extended throughout the life of the contract without artificial barriers. And the understanding of product ranges, which should be gained through conduct of business regulation, must be used to inform the financial side of supervision.

Clarifying Regulatory Objectives

68. Clarity about the regulatory objective is a difficult issue. The representations received by the inquiry from individual policyholders and from their representative groups, along with media coverage of the response to the situation of Equitable, have reflected intense disappointment in the performance of the regulatory system generally. There is a significant gap between the public's expectations of regulation and what people believe has been delivered in this instance. There is a lack of trust in regulators that has transmitted to FSA as if that organisation were in every respect the successor to the now superseded regimes that were in operation down to N2.

69. In this report I have been critical of the regulatory system, and on occasion critical of the performance of regulators and their advisers. But the thrust of my criticism is that for the most part it was the system that failed to provide the regulation that changing circumstances in the industry required, not that there was failure to implement what was fundamentally a satisfactory system.

70. A major lesson to be learnt from the Equitable saga must be that the consumer of financial products should be informed, clearly and succinctly, of the scope of regulation and what can be expected of it. I understand and accept why no regulatory regime can seek to deliver zero failures. The cost of such a system for consumers and providers alike would be disproportionate, and by appearing to insulate consumers entirely from the risk inherent in the selection of an investment product such an approach could give rise to perverse economic incentives for both consumers and providers. However, it is equally clear that building false expectations of regulators can lead to a destruction of public confidence when, as may well be inevitable, a failure such as this one occurs. The responsibility for ensuring that consumers and potential consumers are informed of the objectives of regulation, and of the limitations inherent in those objectives lies with the regulator, and it is a responsibility owed to the consumer.

71. I do not underestimate the difficulty of this task. This is an especially complex area of a complex industry. Many consumers and potential consumers of life products may be ill-equipped to assess the suitability of the products on sale without assistance, and there is no obligation on the consumer to take independent advice. There is an inherent tension between the regulator's responsibilities for the health of the industry and for ensuring that policyholders are treated fairly. Objective quantification of the levels of risk which the system implicitly accepts may prove to be a particularly sensitive or difficult discipline. Nor is it easy to define the role of regulators relative to the directors of the office, or to those providing reports and certificates in support of financial statements.

72. But, effective consumer education is essential. It will not be enough to acknowledge the responsibility to provide necessary education. This is an area in which the regulator must deliver, with or without external support. And the exercise must be kept up to date, reflecting the regulator's response to changing industry practices and the consumer's needs in changing circumstances.

73. Regulators must also take care not to circumscribe their responsibilities in such a way that they create negative expectations: if regulation truly contributed little or nothing to ensuring that policyholders and potential policyholders were treated fairly, for example, it might be better to abandon that aspect of regulation

altogether. That is the clear lesson of the treatment of PRE by DTI in the 1970s and 1980s. The statutory power of intervention generated responsibilities that were not fulfilled, and the reputation of regulation generally was jeopardised.

74. As well as defining clearly the scope of the regulatory function, there is a need, which can perhaps more appropriately be shared with others, to define the scope of individual responsibility. The individual's responsibility for resolving personal issues such as the acceptability of risk with or without the assistance of an independent financial adviser requires particular attention.

75. Reference to insurance companies' financial statements in their current forms would not improve the individual's understanding of the risks and likely benefits associated with the products offered. The typical auditors' report on the Companies Act accounts lacks substance generally, and in any event has its focus in the state of affairs of the office rather than on the characteristics of the products that are relevant to the individual consumer. The appointed actuary is concerned with the health of the fund overall. The published regulatory returns are complex to the point of incomprehensibility: it is clear that Equitable's returns were not understood by GAD actuaries throughout the 1990s. The individual may take, but is not obliged to take, independent financial advice. The definition of the regulator's function and of the reliance that can be put on regulation in the circumstances is complicated by the wider context.

76. Informative pamphlets have a role to play. But there is a need for the contract documents to set out in plain terms the obligations of the policyholder to satisfy himself of the suitability of the product for his needs. It is in this context that simple statements forming part of the contract must be developed. A bald statement of the caveat emptor principle would not suffice. FSA's current proposals for statements beyond PPFMs could provide a basis for a requirement that the policyholder should satisfy himself that a product with the characteristics described met his needs within an acceptable range of risks. This could be made, with other forms and declarations, part of the basis of the contract.

Postscript

77. Many readers of this report will be frustrated that it has not provided answers to two questions: who is at fault for the problems encountered by the Society, and who deserves redress as a consequence? It has been no part of this inquiry to attempt to answer either question. The first inevitably involves issues of the scope of duty and of breach of duty that I was not asked to consider and that I would have been unwilling to consider as part of an inquisitorial process. The current proceedings at the instance of the Society speak eloquently of the complexity of the questions that arise from allegations of breach of duty relating to a relatively short period compared to the period covered by the inquiry, and a selection of issues from the wider range that I have discussed. An open adversarial process such as would have been necessary to replicate the litigation process over the longer period and the wider range of issues would have been beyond contemplation.

78. The second issue is also wide, if less so than the first. I invited individual policyholders to assist me by formulating their claims in order to test policyholders' understanding of the issues, and, if possible, to help form a view about the potential liabilities of the Society at the reference date. The information was not in form or substance sufficient to provide an indication of the Society's total exposure, though it made clear that very substantial claims were involved. But it did expose potential problems of entitlement to compensation and quantification of loss, where loss was recoverable, of considerable complexity. In the light of the investigations I have carried out I understand the Society's current attempts to resolve claims on individual bases: there may be no practicable alternative, though I express no view on the particular approach adopted by the Society.

79. I have set out my findings on the evidence I have recovered. The maxwellisation process has made it clear that those findings are not generally acceptable to those targeted for criticism. Some of the representations, carefully crafted by legal advisers, have reflected positions adopted in the current litigation and could hardly have been expected to have been different. But it must be emphasised that the report sets out my findings, reflecting my assessment of the evidence, and not a consensus statement of the position. Any court or other adjudicator resolving issues of duty, or professional conduct, will require to make an independent assessment of the facts, in default of agreement, and that may agree or disagree with the views I have expressed. Policyholders, in particular, must not base their expectations on the report beyond what it offers: my best assessment of the evidence I have recovered.

80. However, whatever the position on compensation might prove to be in the end of the day, it is clear that many Equitable policyholders have suffered much worry and distress, and many have been and will continue to experience real financial hardship, as a result of seeing the returns they had expected from their savings very dramatically reduced. A hard lesson for many has been that it is the nature of a mutual with-profits office that the members have little recourse to anyone other than the other members for recovery of their own losses. I am in no position to make any general finding as to the manner in which this aspect of their investments might or might not have been drawn to their attention: that depends on what they were told individually and what they understood at the time, and it is clear that individual cases differ. But, with few exceptions, those who have suffered have been the innocent victims of this affair. And it is management of the threat to individuals in similar positions that perhaps has to provide the primary motivation towards reform.

81. It is also clear, however, that many past policyholders gained disproportionately from the administration of the fund, over the 1990s in particular. Payouts on claims, in particular on maturities which did not attract financial adjustments and contributed to the excess claims values described in this report, were payments to individual policyholders who had been members of the with-profits fund. Some re-invested in the with-profits fund, and in some cases recent losses and earlier over-payments may have to be off-set against each other for a proper understanding of the financial position. In this case timing differences have resulted in a range of benefits relative to contributions that cannot be rationalised. This should not characterise the management of a with-profits fund.

82. If the Society recovers damages in the current litigation, the sums will accrue to the with-profits fund, and benefit those who remain members of that fund at the appropriate time and other qualifying creditors of the Society. Inevitably the benefit will accrue to a different constituency from that identifiable at any earlier time. Maturities during the litigation process will not benefit from any recoveries any more than earlier maturities. If the Society succeeds in establishing liability, that will have demonstrated fault on the part of some or all of the defendants in some respects that fall within the ambit of the allegations sent to trial. It will perhaps exhaust the scope for claims that have not expired, though it will not resolve all of the issues that might arise on the facts found in this report.

83. As for the regulatory system, I do believe that it has failed policyholders in this case. This is not, in general, because of individual failures. I do not pin that blame on individuals, who in the main have operated in good faith and to the best of their abilities within the system as they found it. But I do take the view that the system itself was not overseen, and in particular was not kept up-to-date, and operated in an ineffective manner.

84. The deficiencies are not so obvious as some are inclined (or wish) to believe. And, it is seldom enough, and it is not enough in this case, to infer from the coincidence of systems deficiencies and loss that one caused or contributed to the other. Principally, the Society was author of its own misfortunes. Regulatory system

failures were secondary factors. 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. But it may be appropriate to comment 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.

APPENDIX A

OUTLINE CHRONOLOGY

1762	Equitable Life founded, as the 'Society for Equitable Assurances on Lives and Survivorships'.
1848	Founding of the Institute of Actuaries.
1856	Founding of the Faculty of Actuaries.
1870	Life Assurance Act 1870 enacted as a measure to protect policyholders, after an unprecedented level of insolvency of life insurers. Gave responsibility to the Board of Trade.
1913	Equitable Life started to sell pensions.
April 1951	Establishment of Millard Tucker Committee on Taxation of Retirement Benefits.
	Roy Ranson joins Equitable Life.
1953	Publication of 'a(55) Tables for Annuitants (CMI)', providing a new actuarial approach to annuitants' mortality.
February 1954	Publication of the Tucker Committee report into the 'Taxation Treatment of Provisions for Retirement'.
1956	Finance Act 1956, extending the right to self-employed people to tax relief on retirement provision. (Subsequently consolidated into the Income and Corporation Taxes Acts of 1970 and of 1988.)
1957	Equitable Life sold its first retirement annuity (RAP), based on 'a(55)' mortality tables and containing 'Rates of Guaranteed Annuity'. A form of final bonus was applied to retirement annuities to align the annuity at maturity to that which could be obtained from current annuity rates.
April 1963	Equitable's last quinquennial (5-yearly) bonus declaration.
1967	Maurice Ogborn became the Society's general manager and actuary in succession to Henry Tappenden.
1970	Finance Act 1970: signalled replacement of 'old code' tax approval of pensions business by 5 April 1980 and heralded the end of the Federated Superannuation Scheme for Universities (FSSU).
1971	Finance Act permitted partial commutation of RAPs for tax-free cash. Equitable increased the rate of GIR to 3% per annum.
15 May 1991	Management agreement to proceed with introduction of with profits policies with no reversionary bonus.
October 1972	Ogborn retired as the Society's general manager and actuary; replaced by Barrie Sherlock. Ranson promoted to deputy actuary.
1973	Insurance Companies Amendment Act 1973: introduced the prospect of failure to meet the 'reasonable expectations' of policyholders and potential policyholders as a trigger for regulatory action.
April 1973	Equitable introduced a non-guaranteed terminal (later final) bonus. 'Three-call' system of bonus initiated.

1974	Insurance Companies Act 1974 consolidated existing legislation. Section 15 defined the statutory role of the appointed actuary. Sherlock became the Society's first appointed actuary.
August 1974	Product Investigation Team (PIT) set up, under the chairmanship of Roy Ranson.
1 May 1975	Publication of first edition of Institute and Faculty of Actuaries' guidance note 1 (GN1), 'Actuaries and long-term business'. Limited actuaries' freedom to differ from their fellow actuaries; crucial to public (and government) confidence in appointed actuaries and protection of policyholders' interests.
October 1975	Equitable increased the guaranteed rate of interest (GIR) to 3½% per annum and the interest rate in possession to 7%. Originally these had been 2½% p.a. and 4% respectively.
1978	Section 22 of the Finance Act allowed an open market option to be provided, so a pension policyholder could purchase an annuity from a different office.
5 March 1979	Adoption of 1st Life Directive, which inter alia permitted the use of future profits implicit items in calculating regulatory solvency.
20 December 1990	First application by Ranson for use of future profits implicit item.
1981	Insurance Companies Act 1981: implemented 1st Life Directive.
1 January 1982	Ranson promoted to joint actuary with Sherlock, and became the Society's appointed actuary in succession to Sherlock.
1982	Insurance Companies Act 1982 consolidated Insurance Companies Acts 1974 and 1981. This is the main statute governing prudential regulation of the Society during the period covered by this report.
May 1982	John Caldecott retired as the Society's president; replaced by David Murison.
Autumn 1982	Current annuity rates fell below guaranteed annuity rates for a short time during autumn of this year.
1 October 1982	Insurance Companies Regulations 1981 (SI 1981/1654), set out rules for valuing liabilities.
1983	Approach to meeting cost of annuity guarantees out of terminal bonus was decided upon by the Society's management. This approach developed into the differential terminal bonus policy in 1993.
1 October 1983	Publication of first edition of Institute and Faculty of Actuaries' guidance note 8 (GN8), 'Additional guidance for appointed actuaries and appropriate actuaries'.
25 January 1984	'Three-call' bonus system abandoned.
15 March 1984	Insurance Companies (Accounts and Statements) Regulations 1983 (SI 1983/1611)
5 October 1984	Regulatory guidance issued for applications for use of future profits implicit items.
January 1985	Ranson appointed to the Society's board as an executive director.
1986	Publication by Prof. Alan Wilkie of 'A Stochastic investment model for actuarial use'.

May 1986	David Murison retired as the Society's president; replaced by Professor Roland Smith.
December 1986	Association of British Insurers (ABI) published first 'Statement of Recommended Practice on Accounting for Insurance Business' (SORP).
1987	Equitable's last triennial (3-yearly) bonus declaration.
19 October 1987	Black Monday. Largest one-day fall in the stock market since October 1929.
29 April 1988	The Financial Services Act 1986 came into force (referred to as 'A Day'). The Life Assurance and Unit Trusts Regulatory Organisation (LAUTRO) became a self-regulating organisation (SRO), answerable to the Securities and Investments Board (SIB) for conduct of business regulation of life insurance companies, including Equitable Life.
1 July 1988	Personal Pensions replaced RAPs for new business.
1989	Establishment by Equitable of an internal new business loan to capitalise the acquisition cost of new business over the life of each policy.
20 March 1989	*With Profits Without Mystery* presented by Roy Ranson and Chris Headdon to the Institute of Actuaries in London.
April 1989	Equitable policyholders' annual statements changed to show rolled-up policy value to their policies, including non-guaranteed final bonus.
19 February 1990	*With Profits Without Mystery* presented by Headdon to the Faculty of Actuaries in Edinburgh.
May 1990	ABI published second SORP.
August 1990	Responsibility for developing accounting standards passed from the Accounting Standards Council (ASC) to the Accounting Standards Board (ASB).
20 December 1990	First application by Ranson for use of future profits implicit item.
Year end 1990	Society introduced 1¼% differential for first time into the regulatory liability valuation between the gross bonus rate assumed and the interest rate used to discount liabilities.
30 June 1991	Sherlock retired as the Society's general manager and actuary.
1 July 1991	Ranson became the Society's managing director and actuary, whilst continuing to hold the position of appointed actuary.
October 1991	The Auditing Practice Committee (APC) issued auditing guidance 311 (AG 311), 'Life Insurers in the United Kingdom', providing guidance for audit of life insurers.
16 September 1992	Black Wednesday: sterling left the European Exchange Rate Mechanism.
6 November 1992	First indication by Ranson to GAD of the use of a quasi-zillmer adjustment in the 1991 returns.
December 1992	Publication of the Cadbury Report, 'The Financial Aspects of Corporate Governance'.
7 July 1993	Consideration of use of subordinated loan capital first raised by Ranson with GAD.

October 1993	Guaranteed annuity rates "in the money" for a short time.
22 December 1993	Equitable Board adopted differential terminal bonus policy in amended notes to the 1992 declaration.
24 January 1994	Equitable's Audit committee established.
8 February 1994	The Systems and Controls Review Group (SCRG) set up.
9 February 1994	Equitable bonus valuation meeting held, at which introduction of DTBP was confirmed for 1993.
May 1994	Roland Smith retired as president; replaced by John Sclater.
1 July 1994	Improved rules introduced for the sale and marketing of investment products. The Personal Investment Authority (PIA) replaced LAUTRO as conduct of business regulator for insurance companies.
	The Insurance Companies (Third Insurance Directives) Regulations 1994 came into force.
	Insurance Companies Regulations 1984 (SI 1984/1516), set out further rules for valuing liabilities.
1 December 1994	Prudential Guidance Note 1994/6 issued by DTI.
Year end 1994	First use of future profits implicit item in form 9 of the 1994 return.
April 1995	Guaranteed annuity rates "in the money". The GAR liability became increasingly onerous for the Society from this point.
17 July 1995	Publication of the Greenbury Report on directors' remuneration.
January 1996	The Securities Risks and Controls Group (SRCG) established by Equitable.
1 June 1996	GIR for new Equitable pension business sold on or after this date reduced to 0%.
November 1996	SRCG renamed the 'Internal Controls Review Team' (ICRT).
23 December 1996	Insurance Companies (Accounts and Statements) Regulations 1996 (SI 1996/943)
20 May 1997	Chancellor of the Exchequer announced reform of financial services regulation and future creation of a single regulator.
18 July 1997	Society issued £350m of subordinated debt.
31 July 1997	Ranson retired as managing director and appointed actuary. Replaced as managing director by Alan Nash and as appointed actuary by Chris Headdon.
19 August 1997	Application granted for the issue of £350m of subordinated loan capital.
October 1997	Securities and Investment Board (SIB) changed its name to the Financial Services Authority (FSA).
Year end 1997	Interest rate differential eliminated from liability valuation for first year since introduced for 1990.

January 1998	Publication of the Hampel Report on corporate governance.
	ICRT renamed the 'Risk Management Group' (RMG).
5 January 1998	Responsibility for prudential supervision of insurance companies transferred from the Department for Trade and Industry (DTI) to HM Treasury.
12 March 1998	No entitlement to declared (reversionary) bonus for new business sold after this date. All bonus to be in the form of final bonus, added on termination or withdrawal.
1 June 1998	Transfer of responsibility for banking supervision to FSA under the Bank of England Act 1998 effective from this date, which was referred to within the industry as 'N1'.
July 1998	First complaints received by Personal Investment Authority Ombudsman about policies with guaranteed annuities.
August 1998	Equitable's financial position and conduct of its with-profits business came under close scrutiny in the press.
10 September 1998	Publication of Law Commission Consultation Paper, 'Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties'.
December 1998	ABI published third SORP.
1 January 1999	HM Treasury's role as prudential insurance regulator delegated to FSA from this date.
13 January 1999	Originating Summons issued by Equitable to Alan Hyman.
1 April 1999	Date of Headdon's 'side-letter' to the financial reinsurance agreement.
August 1999	The Auditing Practice Board (APB) issued practice note PN 20: 'The Audit of Insurers in the United Kingdom', superseding AG 311.
16 September 1999	Equitable Life won case in the High Court. Mr Hyman was granted leave to appeal.
11 October 1999	Date on which Headdon signed the financial reinsurance treaty.
20 January 2000	Equitable Life lost case in the Court of Appeal; but decided to appeal to the House of Lords.
February 2000	SCRG disbanded by equitable to make way for the new business risk department. RMG evolved into the business risk management group (BRMG). Both replaced by the internal audit function.
May 2000	Publication of 'The Combined Code: Principles of Good Governance and Code of Best Practice'.
14 June 2000	Financial Services and Markets Act 2000 received Royal Assent.
20 July 2000	Equitable Life lost appeal before the House of Lords. Society put itself up for sale.
2 August 2000	Decision announced that no growth would be allocated on with-profits policies for the first seven months of 2000.
23 November 2000	Realisation by GAD of Equitable's use of quasi-Zillmer adjustment.

8 December 2000	Equitable closed to new business. Nash resigned as managing director. Headdon nominated chief executive and appointed actuary.
28 February 2001	Sclater resigned as president. Vanni Treves became chairman.
1 March 2001	Headdon resigned as chief executive and appointed actuary; replaced by Charles Thomson as chief executive and by Peter Nowell as appointed actuary.
6 March 2001	Publication of 'Institutional Investment in the United Kingdom: A Review', by Paul Myners.
29/30 March 2001	Publication by the House of Commons Treasury Select Committee of 'Equitable Life and the Life Assurance Industry: an Interim Report'.
June 2001	Publication of the final report of the Company Law Review Steering Group, 'Modern Company Law for a Competitive Economy'.
16 July 2001	Equitable announced a 16% cut in the value of with-profits pension policies and that, with the exception of contractual guarantees, no growth would be allocated for the period from 1 January to 30 June 2001.
31 August 2001	This inquiry launched by the Economic Secretary to the Treasury. Operative date for the terms of reference.
September 2001	Publication of the Corley Report into Equitable Life.
17 October 2001	Publication of the Baird Report into regulatory handling of Equitable Life between 1 January 1999 and 8 December 2000.
1 December 2001	Financial Services & Markets Act 2000 came into force, making the FSA the single regulator for financial services in the UK. From this date, the FSA replaced the PIA as COB regulator and assumed formal responsibility for prudential insurance regulation. This date was also known as 'N2'.

APPENDIX B

GLOSSARY

ABI	Association of British Insurers
Actuary's certificate	A certificate provided by the appointed actuary of a life office in terms of Schedule 6 to the Insurance Companies (Accounts and Statements) Regulations 1996, and predecessor provisions.
Admissible assets	Asset that can be taken into account for the purposes of a firm's solvency requirements valued in terms of applicable regulations.
AVC	Additional Voluntary Contribution: a payment on a voluntary basis into an employer's occupational pension scheme.
BIA	British Insurers' Association (which became the ABI).
Companies Act accounts	Statutory accounts prepared in accordance with the Companies Act accounting requirements, currently in terms of the Companies Act 1985.
Compromise Scheme	A scheme for compromise between a company and its creditors, or any class of them, under section 425 of the Companies Act 1985. The proposed details of the Society's compromise scheme were published in Autumn 2001 and received sanction from the courts the following Spring.
Conduct of Business regulation	Regulation relating to the sales processes of the company.
Corley	Report of the Corley Committee of Inquiry regarding The Equitable Life Assurance Society (published by the Faculty and Institute of Actuaries in September 2001).
DTI	Department of Trade and Industry. Formerly Board of Trade and Department for Trade. Responsibility for regulation rested with the Board of Trade up to 1970, the Department of Trade & Industry 1970-74, the Department of Trade 1974-83, the Department of Trade & Industry from 1983 to transfer of functions to HM Treasury on 1 January 1999. Website http://www.dti.gov.uk.
Deferred Acquisition Costs	Costs of writing insurance business relating to contracts in-force at the balance sheet date, which are carried forward from one accounting period to subsequent accounting periods in the expectation that they will be recoverable out of future margins within insurance contracts after providing for contractual liabilities.
Deferred Annuity	An annuity that will provide a policyholder with regular income over the policyholder's lifetime after a specified age has been reached.
Director's Certificate	A certificate provided by the direcors of a life office in terms of Schedule 6 to the Insurance Companies (Accounts and Statements) Regulations 1996, and predecessor provisions containing the directors' confirmation that specified matters comply with the rules as stated in the 1994 regulations.
DTBP	Differential Terminal Bonus Policy
ELAS	Acronym for the Equitable Life Assurance Society. Website: http://www.equitable.co.uk/

Estate or Free Estate	In insurance industry parlance, the balance of admissible assets over mathematical reserves held back from bonus distribution to with profits policyholders as a buffer against major fluctuations in investment values or in underwriting experience or in central costs of administration.
Faculty of Actuaries	The governing body for Scottish actuaries, founded in 1856 and incorporated by Royal Charter in 1858. It shares its Board of Management with the Institute of Actuaries supervising the education and development of actuaries and issuing Guidance and Practice notes on various issues. Designatory letters = AFA (Associate) and FFA (Fellow). Website: http://www.actuaries.org.uk/
Final annuity adjustment	An Equitable Life phrase from the early 1960s denoting the granting of a supplement to a deferred annuity contract at maturity so that the amount of annuity received by applying the GAR to the policy proceeds was the same as would have been obtained if the current annuity rate had been applied to the proceeds before adding the bonus.
First Life Directive	Council directive of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life insurance. (No.79/267/EEC)
Form 9	A summary of the general business and long-term business assets allocated towards the relevant required minimum margin thus showing the company's regulatory solvency position. The form 9 position is derived from the other forms that make up the full regulatory return, other than for implicit items of future profit.
FSA	Financial Services Authority. Previously the Securities & Investments Board, the Authority was the agency responsible for regulation of some financial services (and recognition of self-regulating organisations) under the Financial Services Act 1986. It was renamed in October 1997 as part of process of creating single financial services regulator. It took over banking regulation in June 1988 and assumed delegated responsibility for insurance regulation in January 1999. Since 1 December 2001 FSA has had statutory responsibility for financial services regulation under the provisions of the Financial Services and Markets Act 2000. Website: http://www.fsa.gov.uk/
FSMA	The Financial Services and Markets Act 2000
Future profit implicit item	Item that can be counted, within certain limits, towards meeting a company's RMM in respect of its long-term business at the discretion of the regulator. This item allows insurers to take credit for margins in mathematical reserves to the extent that they are expected to emerge in the future from in-force business. See chapter 7.
GAD	Government Actuaries Department central government body employing all actuaries in the government service, amongst whose duties has been the review of regulatory returns and actuarial advice to the prudential regulators for insurance (DTI, HM Treasury and FSA). Website: http://www.gad.gov.uk/

GAR	Guaranteed Annuity Rate –See the foreword paragraph 17.
GIR	Guaranteed Interest Rate (or Guaranteed Investment Return) – an amount by which basic benefits are guaranteed to increase each year before the addition of reversionary (declared) bonus. Originally set by the Society at 2½% per annum on its RAP business, this was raised to 3%, and then in October 1975 to 3½% per annum. Removed from new pension policies taken out after 30 June 1996.
GMT	General Management Team. See chapter 9
GN1	Guidance Note 1: Actuaries and Long-Term Insurance Business. Issued by the Institute and Faculty of Actuaries.
GN2	Guidance Note 2: Financial Condition Reports. Issued by the Institute and Faculty of Actuaries.
GN8	Guidance Note 8: Additional Guidance for Appointed Actuaries. Issued by the Institute and Faculty of Actuaries.
Government Actuary	Head of GAD
Hidden Reserves	Reserves resulting from the underestimation of assets and overestimation of liabilities (other that mathematical reserves)
HMT	Her Majesty's Treasury. Assumed policy responsibility for financial services from 1992 and responsibility for insurance regulation from 1998. http://www.hm-treasury.gov.uk
IB-PIA	Personal Investment Authority Insurance Business Division, a division of FSA that undertook regulatory responsibilities for PIA pending creation of the single financial services regulator under the Financial Services & Markets Act 2000.
IFA	Independent Financial Adviser
IMRO	The Investment Managers' Regulatory Organisation.
Institute of Actuaries	The governing body for English actuaries, founded in 1848 and incorporated by Royal Charter in 1884. It shares its Board of Management with the Faculty of Actuaries supervising the education and development of actuaries and issuing Guidance and Practice notes on various issues. Designatory letters = AIA (Associate) and FIA (Fellow) Website: http://www.actuaries.org.uk/
Insurance Companies Regulations	Refers to the Insurance Companies Regulations 1994 and predecessor editions.
Interest rate differential	Differential between assumed gross bonus rate and rate for discounting liabilities introduced by Society into its liability valuation from 1990 to 1997. See chapter 7.
Key Features / Facts Document	Information about a policy contract which is required to be in format specified by the regulator
LAUTRO	Life Assurance and Unit Trusts Regulatory Organisation...
MVA or MVR	Market Value Adjustment or Market Value Reduction applied by Equitable on non-contractual claims to reduce policy values.
Mathematical reserves	Insurance fund liabilities for regulatory purposes calculated with reference to the present value of future expectations of income, expense and investment yield.

Maturity	The point, other than on death, from which policy benefits become contractually payable.
Maxwellisation	Process by which those subject to potential criticism by an inquiry are given an opportunity to make representations.
Mortality Table	A listings by age of the probable death rates of a similar group of people, based on actual past experience. The table will sow the assumed number of people left alive at each subsequent age from a given age group.
Mutual Life Office	A life insurance company owned by its policyholders rather than by shareholders. Participating policyholders receive a share of the profits earned by the office, in the form of bonuses applied to their respective policies.
New Business Strain	Requirement for capital to support the writing of new business.
Non-GAR	Any Equitable with-profits contract that did not contain an annuity guarantee or GAR. Upon vesting, the annuitant receives an annual income derived by using the insurer's current annuity rate, which will be derived by reference to underlying market rates for fixed interest securities.
Orphan assets	In general terms, assets held by a financial institution that are not immediately attributable to a depositor or investor. In pension and life funds the term is used loosely to describe those assets held in excess of the expected liabilities (see Estate).
PIA Ombudsman	The independent complaints handling agency for resolving complaints by investors against firms which were regulated by the PIA
PIA	Personal Investment Authority. A self-regulating organisation recognised by the SIB (later FSA) under the Financial Services Act 1986.
PIA Review	A review on the mis-selling of personal pensions for the period 29 April 1988 to 30 June 1994. The start date was the date when FSA 1986 came into effect (and when membership of a company pension scheme was no longer a condition of employment). 30th June 1994 was the day before the revised and tighter conduct of business rules came into force, when the PIA took over responsibility for CoB regulation; from LAUTRO of insurance companies and from FIMBRA of financial advisers. Also known as the SIB review and the Pensions Review
PPFM	Principles and Practice of Financial Management. Document describing policy for management of with-profits business which FSA now requires life offices to prepare.
Policy Document	A document that sets out the terms and conditions of the insurance contract.
Policyholder	The person who is the legal holder of the policy for securing the contract with the insurance company
Policy Value	The full current value of the policy. The value of a participating policy will include the value of bonuses assuming the policy will continue until maturity has been reached. This is not the same as the cash value

PRE	Policyholders Reasonable Expectations. Introduced in the Insurance Companies (Amendment) Act 1973. Powers were bestowed to protect policyholders against the risk of a company's inability to fulfil the reasonable expectations of a policyholder. PRE is the ground for use of the residual power of intervention under section 45 of ICA 1982. See especially chapter 13.
PIT	Product Investigation Team comprising senior executives of Equitable. Instigated in August 1974 to review existing products, examine new products and assess their suitability as potential ELAS products and to design and adapt new and existing products
Prudential regulation	Regulation concerning itself with the overall solvency of the company
PSB	Prudential Sourcebook. FSA's rules and guidance effective from January 1 2004.
Quasi-Zillmer Adjustment	A modified Zillmerisation technique adopted by the Society with respect to their regulatory valuation.
Rectification Scheme	Scheme for compensating former policyholders introduced by the Society in response to the *Hyman* decision.
Resilience Test	A requirement for prudent provision to be made against the effects of possible future changes in the value of assets on the adequacy of these assets to meet liabilities. The reserves required to satisfy the resilience test are known as the resilience reserves.
RMM	Required Minimum Margin of Solvency. See chapter 10, paragraph 6.
RSP	Recurrent Single Premium. Refers to contracts that did not require regular policy premiums to be paid. Accounted for bulk of Society's business for much of the period covered by the inquiry.
Regulatory or Required Solvency	The financial status of an insurance company whose admissible assets exceed their liabilities including mathematical reserves. The difference is called the margin of solvency and must be greater than the greater of the "required minimum margin of solvency" and the "guarantee fund".
Reinsurance	An arrangement with another insurer (a reinsurance company) whereby risks are shared for an agreed fee. It enables insurance companies to accept large or unusual risks and reduce the effects of variations in claims experience from year to year.
SCRG	Systems and Controls Review Group established in 1993. See chapter 9
Scrutiny	Refers to examination of Society' annual regulatory returns to the DTI, HMT and subsequently FSA. Under the terms of the service level agreement that GAD entered into with each of these bodies in turn, a report would be submitted commenting on new business written, the minimum solvency cover required, movement in the mathematical liabilities etc.
Section 68	Section 68 of the Insurance Companies Act 1982 under which HMT may by order direct that all or any of the provisions to which the section applies shall not apply to the company or shall apply to it with such modifications as may be specified in the order.

Schedule 4	A subset of forms within the regulatory return containing detailed actuarial information on long-term business. The appointed actuary is also required to give information to demonstrate compliance with the Third Life Directive.
SIB	Securities and Investments Board (became FSA in October 1997).
SLA	Service Level Agreement. SLAs were signed between DTI and GAD in 1984 and 1995, and then between HMT, FSA and GAD when FSA assumed delegated responsibility for insurance regulation in 1999.
SORP	Statement of Recognised Practice. An industry standard of accounting presentation of financial statements.
SLC	Subordinated Loan Capital. A loan which in the event of the winding up of the company is repayable by the company only after all other liabilities of the company (other than those in respect of share capital and amounts which the company may be liable to pay under section 59(4) of the Companies Act 1981) have been paid in full.
SRCG	Securities Risks and Controls Group; later renamed to ICRT – Equitable Internal Controls Review Team.
SSAP	Standard Statement of Accounting Practice.
Third Life Directive	The Council Directive of 18 June 1992 on the coordination of laws etc, and amending Directives 73/239/EEC and 88/357/EEC (No.92/49/EEC)
Wednesbury reasonableness	Test applied by the courts in judicial review of discharge of official functions derived from *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223, CA. In brief the courts will only interfere with a decision that is otherwise lawful or procedurally fair if the decision is so perverse that it can only have been arrived at by the improper exercise of power.
With-profits	A policy that is issued with profit shares in the distribution of surplus from the relevant fund by way of bonuses.
Zillmerisation	An allowance for acquisition costs that are expected, under prudent assumptions, to be recoverable from future premiums. Named after the Prussian actuary, August Zillmer, who first adopted the method of calculating modified life insurance reserves.

APPENDIX C

FEDERATED SUPERANNUATION SCHEME FOR UNIVERSITIES

1. The modern history of the Equitable Life began with intimation of the impending demise of the Federated Superannuation Scheme for Universities (FSSU). Until the 1970s the Society was a small, relatively old-fashioned and generally conservative company. A substantial proportion of its business was derived from the scheme.

2. The background to the scheme was described to the Board on 14 March 1973. The FSSU was a money-purchase scheme funded by joint contributions of university employer and university employee, amounting to 15% of the employee's salary, to assurance policies with an office selected from a panel. Benefits bore no direct relation to final salary. University teachers had considerable flexibility in selecting benefits. If a qualifying member of staff wanted to maximise life cover he or she was able to select endowment assurances. If the individual wanted to maximise retirement benefits, he or she was able to select deferred annuities. The policies were transferable on change of position and university. In the post-war years a fundamental drawback of the retirement benefits scheme became apparent with salary inflation: the proceeds of the policies effected from a fixed percentage of salary over the years provided inadequate benefits at retirement. The State began supplementing pension provision where benefits were below one seventy-fifth of final salary for each year of service. The scheme was given some of the characteristics of a final salary scheme by means of public subvention. The university teachers retained the flexibility of the original scheme with the extra safeguards that afforded.

3. The business was valuable to the Society. In his statement to members in the Statutory Accounts for the year ended 31 December 1966 the president informed members that:

> "Our associated office, the University Life Assurance Society, provides a useful service to the class of member for whom it was designed. The holding has been carried in our balance sheet for many years at what is a purely nominal figure. It seemed appropriate that the holding should be put on a value more in keeping with the income receivable by the parent society and the amount of the writing-up has been carried to the inner investment reserve."

The asset was written up from £29,900 to £1m. Universities business was an important source of revenue. It supported the Society's staff and other resources required to carry on business.

4. The Finance Acts 1970 and 1971 introduced a new uniform code for pensions schemes and prevented the FSSU from continuing in its then current form. Negotiations succeeded in achieving a transitional period to 1980 being allowed for adjustment to the new code. A modified scheme was negotiated and given outline approval by the Inland Revenue by March 1973.

5. In his 1970 statement, the president, Ford Geddes, commented on the effect of the provisions of Finance Act 1970 on occupational pension schemes:

> "They especially affect the FSSU, the pension scheme for University teachers. With our full support, our many friends in the university world have been seeking exemption from those provisions of the Act which prevent the continuation of the scheme in its present form. The Chancellor has announced a postponement till 1980 which, while falling short of exemption, does preserve much of the existing arrangements and gives time for us, and the other life offices involved in the FSSU, to adjust the future arrangements to the best advantage of our University members."

6. Branch expansion had already begun in anticipation of the changes, and is described later. It continued. In 1971, the president reported:

> "The Society is the leading life office in the FSSU ... which has contributed to the expansion of the Society's business. ... The adjustment of the FSSU to the new pension code by 1980 has occupied much time this year and we have been keeping in close consultation with those responsible in the university world."

7. In 1973, the report stated:

> "Since the legislation in Finance Acts 1970 and 1971 has forced amendments upon FSSU, to become effective in 1980, the universities have felt it timely to consider the possible introduction of a self-administered scheme linking pension directly to salary at retirement, and it is expected that the new scheme will be introduced in 1975. The proposed scheme will be compulsory for teachers appointed after April 1975 and it is intended that existing teachers should have the opportunity to transfer to it at any time up to 1980, if they wish to do so."

8. The new scheme was to take the form of self-administered terminal salary scheme. Members transferring to the new scheme lost the benefits of personalised money purchase policies in exchange for benefits wholly related by formula to final pay and years of service. The Universities' Joint Consultative Committee under the chairmanship of Sir Douglas Logan recommended to universities that they should adopt the terminal salary scheme for all new university teachers after April 1975, and that existing FSSU members should be given an option to transfer to the terminal salary scheme, giving up all their rights under FSSU including cash for service to 1980 and protected death benefits, and making over their FSSU policies to the trustees of the new scheme to go some way towards meeting the back-service provision for teachers in the new scheme.

9. Government supplementation was to be withdrawn for future members of FSSU after a date to be fixed. Without that floor it seemed clear to the writer that in an inflationary world no future new entrant could choose FSSU policies. Existing teachers would continue to enjoy the right to supplementation at the current level, but that would mean an effective reduction in support to the member because of differences in the taxation of benefits. When supplementation ended any incentive to remain in the scheme would disappear.

10. The president said that the implications for the Society were uncertain, but to be likely to be that:

1. There would be a terminal salary scheme in existence probably from 1975;
2. There would be no new entrants to FSSU after 1975;
3. There would be few existing members transferring into the terminal salary scheme until the latest possible date which was expected to be April 1980;
4. In 1980 there would be substantial transfers of members especially of the younger members aged under 45, since for those members the FSSU policies would be transferred to the terminal salary scheme trustees, and the future of the policies would depend on the trustees' views of the policies as investments; and
5. For existing members who opted to stay in FSSU incremental policies would be required for about twenty years.

11. In the 1974 accounts, the president reported the universities' decision, and intimated that the Society would continue its association by assisting to ensure a smooth transition to the new arrangements. He continued:

> "It will be apparent that, following the decision of the Universities to set up a new pension scheme, there will be a change in the composition of our business during the next few years as business associated with FSSU is replaced

> gradually by expansion of sales of life assurance and pension policies to individuals and of group life and pension schemes. Previous statements have reported our expansion policy designed to secure a strong future for the Society."

12. A policy of expansion had been initiated before publication of the threat that the FSSU scheme would be undermined by Finance Act 1970. But the loss of the FSSU business was a serious blow to the Society and prompted a drive for new business at what was to prove a critical time. This is discussed in chapter 3.

13. The drive for new business imposed considerable strain on the Society in financial terms and generally. An unusual and inexplicable manifestation of the general strain came to be reflected in a view that FSSU was in an ill-defined way at 'fault' for driving the Society out into the market place to search for new business opportunities. In a report dated 28 November 1979 it was observed that since FSSU had precipitated the Society's need for growth in single premium business, it seemed proper to share the cost of that new business between the universities scheme and the with-profits fund. There was a similar comment in a report dated 25 February 1981. The view may reflect a degree of disappointment at the course events dictated by the changed tax regime. But on any view it does reflect the serious adverse impact on the Society of the loss of the business.

14. The Board of Equitable had repeated discussions on the FSSU position in the course of 1974. Among other references, one demonstrated the impact of the change on the Society's wider role in the industry. On 23 October 1974 it was minuted that:

> "In view of the potential problems arising from the FSSU situation it was decided that the Society should not participate in the consortium being formed to assist (London Indemnity and General insurance Co, Ltd.)"

The implications of the loss of FSSU business became a major influence on the Board's thinking throughout that difficult year. But there was an anxiety to maintain levels of distribution in the difficult financial circumstances of 1973 and 1974, and 1976.

15. In the event, loss of FSSU business became a central factor driving a policy of business expansion between 1973 and 1980. The need to maintain and to project the attractiveness of the Society's policies and bonus practices in support of business expansion in other fields had a significant influence on management throughout that period.

APPENDIX D

TEXT OF TREASURY LETTER TO MANAGING DIRECTORS, 18 DECEMBER 1998

Dear Managing Director

GUARANTEED ANNUITY OPTION COSTS AND POLICYHOLDERS' REASONABLE EXPECTATIONS

As you will know the Government Actuary's Department undertook a survey of life offices' exposure to guaranteed annuity options (GAOs) earlier this yew. The results of that survey indicated that the exposure to GAOs was relatively widespread within the industry and had the potential to have a significant financial impact on a number of companies. The nature of the guarantees offered by companies varied widely, but one issue that needed to be addressed by all companies was how the concept of policyholders' reasonable expectations (PRE) should be Interpreted in the context of GAOs. The purpose of this letter is to provide some guidance to companies on the Treasury's interpretation of PRE in these circumstances.

As a starting point, we take the view that policyholders entitled to some form of annuity guarantee or option on guaranteed annuity terms could reasonably be expected to pay some premium, or charge, towards the cost of their option or guarantee.

<u>Charging for the cost of providing a guarantee or annuity option</u>

For linked contracts, any charge would have to be included within the normal explicit charges levied under the terms of the contract, and these charges could clearly only be raised to cover the costs of guarantees to the extent that this was permitted under the contract. Any cost arising to the office in respect of meeting the guarantees over and above the accumulated charges, would therefore have to be covered by the insurer from other available resources.

In the case of participating policies, any charge could be deemed to be met out of each premium received (or the investment return to be credited by way of bonus), and hence would impact on the assessment of bonuses, including in particular any terminal bonus that would normally be payable to the policyholders. Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.

Under the majority of participating policies which have been written it appears that any guarantee or annuity option is applicable to at least the guaranteed initial benefit under the policy and any attaching declared bonuses. As a consequence of this, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to the annuity on the guaranteed terms. However as indicated above, it would appear possible, depending on the particular circumstances relating to the contract, that any terminal bonus added at maturity may be somewhat lower than for contracts without such options or guarantees, and that this terminal bonus could in some cases be applied at current annuity rates.

Apportionment of costs of GAOs not recovered under the relevant contract

In the case of both participating and non-participating contracts any residual cost for the insurer in respect of annuity options and guarantees will need to be recovered from available resources within the long term fund or from shareholder funds.

Where the long-term fund is to be used, we would in the first instance expect to see the cost met out of any 'estate' held by the company. However, where the cost is significant relative to the estate available, then an insurer may wish to consider adjusting the future bonus allocations for some or all of its participating policyholders, or making a transfer to the long term fund from the shareholders' fund.

The appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of all their policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere.

The above is the Treasury's considered view, and is without prejudice to any decision of the courts which may affect it.

Please supply a copy of this letter to your Appointed Actuary,

Yours sincerely

Martin Roberts
Director, Insurance

APPENDIX E

FSA'S PROPOSALS FOR REGULATORY CHANGE

Introduction

1. Reform of the regulatory system has been an ongoing process while I have been undertaking this inquiry. Shortly after my appointment, the report of a committee chaired by Ronnie Baird into the regulation of Equitable between 1 January 1999 and 8 December 2000 was published and submitted as evidence to the inquiry[1]. This report contained a detailed analysis of evidence, both documentary and oral, relating to the activities of prudential and conduct of business regulators and of GAD over that limited period. The inquiry has not sought to provide an analysis in similar detail for that period. In general the Inquiry has found no reason to dispute the purely factual material narrated by Baird, and where there have been differences of fact or inference I have set out my own views. In chapter 7 of the report, Baird summarised the committee's conclusions and made recommendations for change.

2. Earlier, in June 2001, FSA had set out in its consultation paper 97 proposals for an integrated 'prudential sourcebook' to replace the interim rule books adopted by the new single regulator in anticipation of the new regime under the Financial Services & Markets Act 2000. While the inquiry has been continuing, FSA has continued to bring forward detailed proposals for new rules and guidance to apply under the new regulatory system, taking forward and going beyond the proposals set out in the Baird Report, subject to a full consultation process that has allowed for professional and industry views to be explored and assessed in the development and refinement of proposals put to the insurance sector in a series of consultation papers, discussion documents and policy statements.

3. The output from this exercise to date has reflected a major, comprehensive re-assessment of the requirements of an efficient regulatory system for the insurance sector. The process has not been completed. And it is unlikely that there will be finality. FSA's powers to make rules and to provide guidance as set out in the 2000 Act will not be exhausted by publication of the integrated prudential source book and any associated guidance. Adaptation to the changing requirements of effective regulation will be necessary and will ensure that further changes will be proposed, explored and implemented or not as the process continues. Chapter 5 of consultation paper 202, of September 2003, already anticipates further change. Not least among these indications of future change is the need to align reporting requirements to emerging international accounting standards and the 'Solvency II' stage in the development of European regulatory requirements.

Foundations of Regulatory Reform

4. The foundations for the future operation of the new regulatory system were set out in FSA consultation paper 97, along with the first draft of the integrated prudential sourcebook, which is to come into effect from January 2004. This paper began by setting out the requirements for each of the main risks that could lead to a major financial loss or insolvency of an institution. The risks identified were credit risk, market risk, operational risk, insurance risk, liquidity risk and group risk (where applicable). How individual requirements would be set on firms was not yet covered. The paper noted that the aim of the prudential source book was to highlight and facilitate a clear understanding of was and was not achievable through regulation, and that the risk of insolvency was an occurrence that would be

[1] Report of the Financial Services Authority on the Review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000, submitted as evidence to the Inquiry conducted by Lord Penrose. Ordered to be printed by Parliament, 16 October 2001.

impossible to prevent. In fact, it was noted that this was a requirement which would have been an onerous, intrusive and costly to firms and to the regulators.

5. It will be appropriate to trace the development of some of the proposals. But note should be taken at the outset of FSA's policy stance on regulation generally. This was summed up in the FSA's September 2003 paper 'Regulation in a non zero failure world'; which set out the thought behind the FSA's non-zero failure regime and the implications for its regulatory activities. This was not a statement of new policy but a considered position that has been reached in the process to date.

6. FSA accepted that it was unachievable and undesirable to prevent the insolvency of all firms. They noted that they were committed to correcting many forms of market failure but that the failure of an individual firm did not indicate market or regulatory failure. The stated position was to set financial resources requirements in proportion to, not just the risk of failure of a firm, but the impact that a failure would have on its customers and on market confidence in general. With their risk-based approach to regulation, FSA have stated that they have decided to target resources to areas that offer the greatest risk to their objectives. To achieve this, they have said that they have developed a framework for allocating resources against risks, according to probability of failure and impact on consumers.

7. FSA have also stated that there are no guarantees that any regulated firm will not fail or that there will be no lapses in conduct of business regulation. They hope that by encouraging an awareness of the prudential regime amongst potential consumers, this will promote prudent behaviour by consumers and thus enable FSA to meet its core objectives; maintaining market confidence, promoting public awareness, protection of consumers and reducing financial crime, all of which are set out in the Financial Services And Markets Act 2000. This act also states that consumer protection means securing the appropriate degree of protection for consumers rather than removing all the risks. It is also noted that there will be circumstances, consistent with FSA principles, where failure or conduct lapse do occur but would not represent regulatory failure.

8. This September paper also the then chief secretary to the Treasury in 1999:

> "Protecting consumers does not mean absolving people of responsibility for their investment decisions. It is of course the job of the regulatory system to ensure that consumers have sufficient information to make an informed choice. Consumers have a right to that but it is not the job of regulation to provide a guarantee that nothing can ever go wrong."

The idea of a non-zero failure regime is not a new one. This philosophy has been in existence from the time of DTI regulation of the insurance industry. This is evidenced in the files relating to the 1973 Act, and was expressed in interview by one witness who was a senior supervisor at the DTI in 1992:

> "Within regulation there was a question of balance. Too much intervention hindered the market but if we weren't tough enough, companies could take liberties. Conversely, if there were no companies failing then it would be perceived that we were taking too heavy handed an approach. We were not there to prevent companies from failing."

A similar philosophy has applied to regulation of other sectors of the financial services industry, for instance banking. The systemic risks inherent in appearing to insulate the public entirely from the consequences of investment decisions have long been recognised. FSA have characterised this by saying that regulation can restrict instances of mis-selling, that is where consumers are misled by providers, but that consumers need to take responsibility for instances of 'mis-buying', i.e. a loss due to price fluctuation or an error of judgement.

Financial statements

9. Much of this report has been taken up with an analysis of the financial statements of the Society presented to members and policyholders, or to regulators, and a comparison of the picture that emerged from the published material with the realistic position of the Society recorded internally. It has been a major contention that the Society's published financial statements did not uncover the Society's realistic position. Various forms of financial engineering; a lack of published information about aggregate policy values, including accrued terminal bonus; and the failure to recognise the cost implications of meeting policyholders' reasonable expectations, based on current practice, that terminal bonus would continue to be paid, subject to emerging market conditions, lay at the centre of that issue.

10. In their published consultation papers, FSA set out for discussion proposals for a new prudential sourcebook and the prudential requirements that it was intended should apply to life insurers. Throughout the course of their consultation with the industry as a whole, these proposals have been amended and refined in the course of the consultation process. The most recent statement of their current position in this process being consultation paper 207[3]. Many of the proposals within have been aimed at simplifying and facilitating the understanding of annual returns, or enabling comparisons between providers of long-term business to be carried out on consistent bases. It was intended that annual returns complying with the proposals would:

- Improve the timeliness and quality of the information received;
- Improve transparency of the key risks to which the entity is exposed;
- Ensure greater consistency of reporting of key product risks;
- Allow easier comparison and benchmarking of firms; and
- Allow external users of returns to make more informed decisions about firms and the industry.

These are important proposals but presentation is ancillary to the more fundamental issue whether necessary information is properly reflected in the statements in the first place. It is FSA's proposals for ensuring that the information is relevant and adequate which are of primary concern for the purposes of this report.

The 'Twin Peaks'

11. As set out in consultation paper 97, FSA's stated aims and proposals were intended to deal with and set requirements for risk, which could cause a firm to either suffer from major losses or become insolvent. The risk areas that had been identified were; credit risk, market risk, operational risk, insurance risk, liquidity risk and, in appropriate cases, group risk. It was noted that insurance firms would have two main obligations:

- To maintain adequate resources: offices would be required to measure their exposure against each of the risk categories listed (except operational risk) and hold capital resources against them; and
- To maintain adequate systems and controls for managing their risks.

12. It was said that recognition of these obligations in financial statements would lead to a number of significant changes affecting insurers. These would include:

- An increased emphasis on the identification and management of risks relative to the adequacy of technical provisions and the solvency margin.

[3] Treating with profits policyholders fairly – December 2003

- A requirement that firms take a view of the overall level of financial resources required to enable them to meet their liabilities, and development of appropriate stress tests and scenario analysis to support their assessments.
- Extensive new guidance on systems and controls and simpler asset valuation rules more explicitly linked to the relevant market or credit risks.
- Clearer requirements on managing with-profits business, including codifying existing practice on attribution of estates. There would be an explicit requirement for terminal bonus provisions to be included in the balance sheet.
- Increased base capital requirements to reflect the changes to EU directives as a result of the 'Solvency I' review.
- New requirements relating to the outsourcing of key functions, reminding firms of the need for certain procedures to be exacted to address the risks that could arise where firms outsourced certain functions that were material to the risk profile.

13. In marked contrast to the position over the period studied, the current regulatory returns that formed the background to these, and later FSA proposals disclosed terminal bonus rates. But the information provided did not assist the reader to calculate policy proceeds. FSA proposed to remove the requirement to disclose terminal bonus rates in the valuation report and to substitute a new form showing maturity payouts and surrender values for specimen policies and the amount of terminal bonus and market value adjustment included in, or subtracted from, the payout. All reporting firms would be required to provide this information to give a comprehensive picture. The proposal was that the return would show policy payouts as at 1 January, to give firms sufficient time to compile the information before submitting the annual return. FSA recognised that many firms changed their terminal bonus rates in the early part of the year as a result of the annual valuation investigations. FSA stated that they would continue to ask firms for their payouts at other dates in the year.

14. In November 2001, FSA published a paper covering the action that it had already undertaken or planned to take to implement the recommendations set out in the Baird Report. Among other criticisms of prudential regulation the Baird report had concluded that it did not take account of the nature, diversity and scale of risks in insurance firms. FSA proposed to strengthen the prudential regime by improving the basis on which solvency requirements were determined by placing more explicit responsibility on firms' management to maintain proper systems and controls, and by improving public and regulatory reporting. It was envisaged that this would address several of report's recommendations, including provisions for guarantees and options, financial reinsurance, the responsibilities of the appointed actuary and the regulatory returns as well as solvency.

15. The Baird report had said that prudential regulation had been too reactive and been overly reliant on desk-based returns. FSA responded to this by stating that they proposed to institute a more proactive risk-based approach to regulating insurance. More responsibility would be placed upon the management to maintain adequate standards and come into line with other areas of financial services (in areas such as corporate governance, risk management and systems control). All firms would be expected to comply with their obligations under FSA principles, and to deal with the regulators in a more open and co-operative way.

16. FSA initially addressed the area of enhanced capital requirement in consultation paper 143, dated July 2002, which dealt with feedback from consultation paper 97. This paper identified the risk that an office using the net premium method of valuation might fail to retain enough reserves to maintain policyholders reasonable expectations that bonuses would increase if markets

improved. They put forward an approach to avoid the potential problem of 'margins on margins', proposing that an office hold the higher of:

- Their current calculation of mathematical reserves plus the EU directive capital requirement; and
- A realistic value of the sum of (a) expected future contractual liabilities; and (b) projected fair discretionary bonus payments.

If the sum of the realistic elements was greater than the mathematical reserves and the EU directive capital requirement, the office would be required to hold 'top up' capital, designated the 'with profits insurance capital component'. This became the FSA's 'twin peaks' approach. It is intended that this approach will operate in a similar fashion to the approach used in banking supervision.

17. These proposals were developed further in consultation paper 195[3] dated August 2003. They included:

- Reserving and capital requirements for with profits business, ensuring that firms could adequately cover their expected contractual liabilities and discretionary payments (such as terminal bonuses).
- That firms tested the adequacy of their financial resources by carrying out appropriate stress and scenario tests, thus enabling FSA to tailor its individual capital guidance taking into account the firms business and control risks; and
- Other associated reporting requirements, particularly those that related to with profits business.

This paper revised the approach initially set out in consultation paper 143. The changes proposed were

- The removal of the requirement for mathematical reserves for conventional with profits business to be calculated using the net premium method. The requirement to adjust the assessment of future premiums would be removed.

Mathematical reserves would no longer be required to include an allowance for future discretionary bonuses. The draft rules and guidance would allow a firm to change from a net premium method of calculation to a gross premium basis, but only if the firm operated a twin peaks approach. The result of this change would be that mathematical reserves would only be expected to represent a reasonable assessment of contractual benefits. Future discretionary benefits would be separately assessed and explicitly reserved for under the realistic peak instead.

- The introduction of a requirement for a risk capital margin in the realistic peak ensuring that the with profits insurance capital component calculation had an allowance for adverse experience, risk capital margin being defined as the additional capital a firm would require to cover the effects of a prescribed market scenario. It would address major business risks such as market risk, credit risk and persistency risk a firm conducting with profits business would face.

18. It was proposed that the twin peaks approach would only apply to firms that had with profits liabilities greater than £500m, its use being discretionary for firms with liabilities below this figure. Smaller firms would be excluded from this requirement due to the higher comparative cost of introducing a realistic approach. However, these firms would continue to use the net premium valuation method. All firms would be required to hold the EU minimum requirement at least. The effects of these changes would be to reduce the required provisions when markets, and subsequent projected discretionary bonus payments, fell.

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[3] Enhanced capital requirements and individual capital assessments for life insurers – August 2003

19. Any firm that chose to undertake this approach would be required to assess the financial resources needed for with profits business as part of a 'Pillar one' requirement (admissible assets less foreseeable liabilities). Firms would need to consider the Insurance Companies Act and financial resources stress and scenario testing requirements separately. The FSA stated they were trying to introduce a degree of harmonisation between financial sectors.

20. FSA stated that it would accept the asset share approach and the bonus reserve approach as acceptable when a firm was calculating its realistic liabilities. They assumed that firms using the twin peak approach would have access to the gross premium, contractual method and other modifications to the mathematical reserves and thus be capable of a more robust assessment of their realistic position.

Factors relating to Equitable

21. The report has identified the Society's use of a quasi zillmer adjustment its failure to reserve properly for annuity guarantees, and its application of financial reinsurance as failures to comply fully with the existing requirements. The FSA's discussion of zillmerisation reflects the position that had been obtained at all material times. Equitable's quasi zillmer adjustment was not adequately described or disclosed in the Society's returns. The requirement that all should comply with their obligations under the FSA's principles, and deal with the FSA in a more open and cooperative way should ensure that problems do not recur, provided that discipline is effective.

22. With regard to guarantees and options, FSA set out plans in consultation paper 195 to require all firms to reflect any guarantees and option obligations at market value, or to value them according to market based stochastic modelling techniques to ensure that they reflected the time value of these options and guarantees. If this approach was not possible, FSA stated that a firm could derive a valuation via deterministic projections, but this approach was identified as a less desirable option. It was further stated that a firm would be required to reserve against the possibility that an option, not of value to a policyholder at the present date, might become so in the future.

23. The Baird report recommended that the exercise of discretion over the use of future profits implicit items be reviewed. FSA responded that new guidance would strengthen the requirements of firms to show the existence of future profit and provide a more precise requirement for close monitoring by management. The FSA noted that the use of future profit implicit items would be restricted through changes to the EU directives, as part of the Solvency I review. This was discussed in consultation paper 181[4], when it was noted that future profits implicit items would be phased out between 2007 and 2009. FSA further noted that they proposed to exclude future profits implicit items from the definition of capital over that time period also.

24. It was also proposed that waivers would not be granted under section 148 of the Financial Services Markets Act for future profits implicit items, to count towards a firm's minimum capital requirement, where the implicit item would increase regulatory surplus to more than the realistic surplus on the fund. That restraint was in addition to the limits derived from the life assurance directive[5] amended by Solvency I directly. By 2007, future profits implicit items would have to be restricted to 25% of the lesser of the long term insurance capital requirement and total eligible capital resources. By 31 December 2009, it was stated that they would no longer apply.

Reinsurance

25. Financial reinsurance supported Equitable's regulatory solvency position at critical times. It was identified in the Baird Report as an area that required review

[4] Implementation of the Solvency I directives – April 2003
[5] Council Directive 92/49/EEC

and the FSA response was that they intended to deal with this issue. The issue was addressed in consultation paper 144[6], dated July 2002, which set out the approach that would be taken to firms' use of financial engineering. This paper noted that the use of financial engineering instruments was likely to be reduced if accounting standards for insurance moved towards a fair value basis and a more risk sensitive European prudential regime was introduced. The FSA expected that, in the medium to long term, weaknesses concerning financial engineering in the prudential regime would be likely to be resolved by adopting internationally recognised accounting standards for insurance and through new more risk sensitive EU capital and solvency requirements. The paper stated that a start in that direction had already been made in the Solvency I directives.

26. The paper discussed regulatory issues concerning financial engineering. In relation to financial reinsurance, three categories were identified. The first involved a genuine transfer of risk where the price was small relative to the regulatory credit gained because the regulatory charge for the risk was high compared with the market cost charged by a third party to take on the risk. The regulatory objective in that case was to ensure that there was a proper transfer of risk, that the credit taken was appropriate and that collateral risks were properly considered. The second category involved a transfer of risk, but for a price charged on the future resources of the firm, potentially to the detriment of consumers. In life business, the regulatory rules were then poorly aligned to accounting rules and the realistic position was not disclosed. The aim was to increase awareness of the firm's entire situation, including an assessment of its realistic financial position.

27. The third category was described as follows

> "In some arrangements, there is no genuine transfer of risk but full credit is taken for the 'protection' purchased. Practical examples of this have arisen by virtue of side letters which negate the value of the main contract but which are not disclosed or allowed for in reported results. These arrangements are clearly the most unacceptable. Some may even have been deliberately misleading and there will typically have been non-observance of existing regulatory and other requirements. The ABI SORP, for example, requires 'entire arrangements' to be taken into account. In these circumstances what is needed are better tools and warning indicators to help supervisors and auditors to spot potential transactions warranting further scrutiny. Classic warning signals will be large credits for apparently low cost."

The warning signals can be seen to have been the distinguishing feature of the second category also.

28. FSA recognised the validity of financial engineering as a means of strengthening a firm's solvency position. They have highlighted the strengthening of supervisory scrutiny of financial engineering arrangements partly through the administration and scrutiny of applications for waivers for implicit items, where scrutiny has been enhanced since the Financial Services Markets Act came into effect as an aspect of the risk based approach to supervision. They further note that attention will be paid to whether firms' senior management has:

- Satisfied itself that any financial engineering that the firm uses has a legitimate commercial purpose and effect;
- Has reviewed the effect of any financial engineering on the firm's financial position, both current and future within the context of its overall risk management strategy;
- Sets up and maintains proper systems and controls to monitor, manage and record such arrangements; and

[6] A new approach to firms' use of financial engineering – July 2002

- Has ensured these arrangements are reported in the relevant parts of the regulatory return as required.

29. FSA noted that supervisors would be given enhanced training and guidance on how to identify and diminish risks in this area. Any issues identified would then be discussed with the firm's risk management and internal audit functions. They stated that more use would be made of specialist expertise and 'grey panthers', and skilled persons reports would be commissioned when necessary. Firms would also be required to provide any additional disclosures in the regulatory returns they considered necessary to aid users' understanding of the type of arrangements involved or entered into and their effect, consistent with their obligation to treat customers fairly.

30. These proposals dealt with the problems that arose from Equitable's financial reinsurance arrangements, whether assessed in the light of the documents originally disclosed or those documents supplemented by the side letter, whatever its effect. The FSA's proposals, recognising that there are no absolutes in this area, provide for appropriate levels of testing and assessment of the credit claimed for financial engineering.

31. In 1990 and 1994 Equitable released surplus by changing the approach to its valuation interest rate in the regulatory returns. In consultation paper 202, FSA has proposed a revised Form 57 setting out an analysis of the valuation interest rate used for each product, to demonstrate compliance with Rule 5.11 (the determination of liabilities).

32. The overall approach involves simplification of the amount and of the presentation of data. In existing returns the relevant data is spread between different paragraphs forms and notes. The new forms are intended to enable users to identify changes in the valuation bases, and will present, in tabular form, the relevant rates for the current and previous years. Provision will be made for the publication of mortality or morbidity assumptions either in tabular form or by narrative and examples. Expenses data for the main classes of business will have to be disclosed.

33. These proposals would not prevent a change of valuation basis such as occurred in 1990 and 1994. But they would ensure that the relevant data was presented clearly for the benefit of regulators and other readers.

Prudential regulation generally

34. It is FSA's position that the reform process will not be complete on implementation of the current proposals. Bearing in mind the competitive position of the UK in the provision of financial services, FSA have chosen not to anticipate the introduction of new international standards in areas such as operational risk to the extent that these would impose additional costs on firms, or to harmonise existing requirements by levelling up to the highest international standard on all firms regardless of sector, largely because of adverse effects on the international competitive position of the UK. There has been recognition that future International Accounting Standards may impact the balance sheet aspects of annual returns. FSA trust that their proposals will work alongside these changes and that is the reasoning behind why FSA currently propose limited changes to the publicly available annual return. International Accounting Standard changes will be expected to focus on the valuation method of assets and liabilities, which are not reviewed by FSA. They have noted that implementation of the new International Accounting Standard for insurance contracts will not come into effect before 2007.

35. The approach of the integrated prudential sourcebook will be based on an assessment of the impact of prudential failure rather than on the assessment of risk of prudential failure more generally. FSA has indicated that standards will be set that seek to measure and reflect the risks firms run and set the level of appropriate capital resources required, rather than increasing the level of capital resources to be maintained on more general criteria. Within the twin peaks approach, the insurance

solvency margin requirements have been set in accordance with EU minimum standards, which FSA feel might deliver low capital resources requirements relative to the risks posed by some firms. Where this is the case, firms will be required to make and justify their own estimates of required resources to result in higher levels of required regulatory capital

36. FSA accept that it is impossible and undesirable to seek to prevent insolvency of all firms. Their aim is to set financial resources requirements proportionate not just to the risk of failure of the individual firm and also to the impact of failure on consumers and on market confidence, but to aim short of requiring insurance firms to hold any amount of financial resources to protect consumers against any risk of loss.

Individual Capital Adequacy Standards

37. FSA has stated it proposes to introduce individual capital adequacy standards to meet its aims of:

- Ensuring that firms hold capital appropriate to their business and control risks;
- Emphasising the responsibility of senior management to ensure that a firm holds adequate financial resources;
- Providing incentives for better risk management; and
- Enhancing consumer protection and market confidence through a reduced but not eliminated risk of financial failure.

From January 2005, they expected life insurers to be able to maintain overall financial resources of quality and amount to ensure that there was no significant risk that they would be unable to meet their liabilities when they were due. To do this, firms would have to have had in place adequate systems and procedures to assess that they had sufficient resources to facilitate this, that they were able to identify any major sources of risk to ascertain the appropriate level of resources needed and to conduct appropriate stress and scenario tests on any major risks that they identified.

38. Firms will be required to self-assess their capital requirements, this process being known as an individual capital assessment. They will not be required to report these exercises regularly to FSA but will need to keep all records of their assessments, in line with prudential rules. The enhanced capital requirement or minimum capital requirement, if applicable, will be taken into account prior to giving individual capital guidance. The more that firms are able to demonstrate that their risk assessment processes capture and quantify all of the issues in FSA's guidance, then the lower the level at which FSA will be able to assess their individual capital guidance (and vice versa). A firm's individual capital adequacy will remain private between the regulator and the firm. Individual capital guidance given to a firm will not be published. The individual capital adequacy framework was planned for implementation in the latter half of 2004.

39. FSA have noted that they expect individual capital guidance to be targeted particularly at firms with:

- Poor controls and or weak management where capital may be a temporary solution;
- Exposure to areas with greater underwriting uncertainty such as longevity or morbidity risks;
- Material amounts of with-profits business with embedded optionality and guarantees in the underlying contracts; and
- Rapid growth.

40. If the proposals in hand for the future operation of the new regulatory system are implemented, and if they are made effective in practice, in and after 2004, the major criticisms of the earlier regulatory system will have been addressed, both in relation to the general approach to regulation and in relation to the particular issues arising from the discussion of regulation of the Society. It is appropriate to offer encouragement to FSA to institute and maintain an appropriate system of prudential regulation, within the scope of the aims already set; to ensure that it is made effective by the application of appropriate resources; and to ensure that it remains relevant to changing industry needs.

Conduct of Business regulation

41. The criticisms of conduct of business regulation as it applied to Equitable have focused on two main issues: the lack of co-ordination between conduct of business and prudential regulation; and the lack of effective scrutiny of product management after point of sale. In the case of the Society's typical recurrent single premium contract the second issue was particularly relevant to the failure to consider the provisions that dictated an annual review of the relationship, in view of the lack of obligation to pay further contributions until agreement was reached and reflected in endorsement of the contract.

42. The Baird report made a number or recommendations in this area. It commented that, as the committee found the facts, the Equitable case had revealed uncertainty about the interpretation of the conduct of business rules and the standards of disclosure that should be expected of firms where customers were potentially exposed to significant operational risks, and recommended:

> "We recommend that the FSA considers what standards of disclosure should apply [when customers are potentially exposed to significant operational risks] and the extent to which these can be codified."

43. In the paper of November 2001 already referred to, FSA stated that this point was covered in the proposals for the integrated prudential sourcebook as per consultation paper 97, and that the recommendation would be covered in detail as part of the With-Profits Review. It was intended to propose that key information should be presented in summary form. Views would also be sought on the disclosure of asset shares to allow a better assessment of a fund's ability to meet guaranteed and discretionary benefits, which would be of great use to informed users of such information (such as IFAs, rating agencies etc...) who advised on such matters. A discussion paper would be published in Spring 2002 to consider the format, frequency and public disclosure of reports.

44. The Baird report also noted that the role of the enforcement division deserved attention. The committee's impression was said to be that once an issue had been referred to enforcement, there was limited communication between the investigating team and the team responsible for monitoring the Society. The lack of effective interaction was said to have meant that the opportunity to use enforcement, as a source of information regarding Equitable's treatment of policyholders, was lost and the implications of the House of Lords' decision on the investigation were never fully considered by either the enforcement division or the personal investments authority insurance business division. It was recommended:

> "...that steps be taken to rectify the shortcomings and, in particular, to ensure that information in the hands of the Enforcement team is made available to the regulator and vice versa in a timely way in order to improve management of the matter and thereby overall consumer protection."

FSA commented that it was implementing changes to ensure that advice and information flowed freely in both directions between enforcement and the supervisors and that management ensured that this was the case

45. The Baird report further commented that in the context of long-term business, the prudential regulator had responsibilities relating to PRE and customers'

interests, which were created and shaped by communications with policyholders. This was said to represent a matter of potential concern shared with the conduct of business regulator who had responsibility for ensuring that relevant communications with customers complied with its rules. The Baird committee's view was that, in the context of the Society's case, this area of common interest was not effectively managed. It was recommended:

> "...that as part of the integration these two regulatory divisions, the FSA takes steps to ensure that responsibilities in this area are comprehensive and properly coordinated and managed."

46. The Baird report had welcomed FSA's decision to create one division, comprising prudential and conduct of business regulators and GAD, to deliver integrated supervision of the insurance industry. FSA referred to these comments in that context, in response to the recommendation. They noted that they had already made a number of changes to their internal structure to aid its delivery of an integrated approach to insurance regulation. They highlighted that, from 2001, the largest insurers had been supervised by the major financial groups division rather than by the insurance firms division. This had allowed a common approach in regulation of large financial service groups. Communication between these two divisions was said to be essential to allow a common and coordinated approach to significant events (including identification of new sector wide risks). FSA further noted that managers in both of these divisions were already responsible for prudential and conduct of business regulation.

47. Policy relating to insurance industry firms had been consolidated in the prudential and conduct of business handbooks to facilitate a consistent approach to regulation and policy formation. FSA commented that supervisors also had more time to concentrate on supervisory issues as the authorisation division dealt with much of the work involved in authorisation of firms and routine notifications submitted by firms to the regulator. It was also pointed out that staff from GAD had been transferred to the Insurance Firms division in April 2001. Location in the same premises would achieve the aim of providing greater knowledge sharing, access to suitable technical expertise and speedier identification of potential industry concerns. It also enabled the all the relevant bodies to be more closely involved in regulatory process and policy work.

48. In summary, FSA's position in their November 2001 report was that the changes already implemented were:

- FSA now had responsibility for consumer products pre and post sale. Previously, responsibility towards consumers and products had only been recognised up to and including the point of sale;
- Their unified conduct of business sourcebook had come into force;
- The focus on senior managements responsibility for systems and controls had placed a greater obligation on the management to ensure that their firms met the standards laid down for service provision to customers;
- Conduct of business issues had been embedded into the supervisors assessment of a firms risk profile and their selection of regulatory tools applicable;
- The new framework to capture and assess risks and opportunities which face consumers and/or run across industry sectors, of which the risks associated with poor standards of advice were the most obvious;
- Formation of a new division to support work carried out by the FSA to meet their consumer led objectives (i.e. improving the financial literacy of the public).

49. The integration of enforcement functions with regulatory functions raised issues of some complexity that the Baird report did not reflect. The collection of

information for regulatory purposes and the assembly of evidence for enforcement have usually been regarded as requiring different approaches best reflected in maintaining the independence of the enforcer, who could then concentrate on ensuring the integrity of the materials with a view to meeting challenges in subsequent proceedings. To date, FSA's publications have avoided this issue.

50. In January 2003, consultation paper 167 published proposals that arose from papers published as part of the With-Profits Review, and spanned the areas of prudential and conduct of business regulation. The initial proposals in this consultation paper discussed the idea of principles and practices of financial management documents. It was proposed that with-profits firms would be required to:

- Define and make publicly available the Principles and Practices of Financial Management (PPFM) applied in their management of with profits funds;
- Ensure that their governance arrangements offered assurance that they had managed their funds in accordance with the PPFM that they had established and published; and
- Produce annual reports for with profits policyholders on how they had complied with this obligation, including how they had addressed any competing or conflicting rights, interests or policyholders expectations and, if applicable, shareholders.

51. The feedback on this consultation paper was published in Policy paper 167, dated June 2003. The FSA had decided that firms had to define and make available their PPFMs by the end of March 2004. Consistency would be required between the assumptions underlying any projections on which realistic reserves were based and the PPFM disclosed to with profits policyholders. These would have to be reported and disclosed publicly. A number of general and specific issues were clarified, and criteria for acceptable definitions and statements of PPFMs were set out

- Statements lacking the detail necessary to enable a knowledgeable observer to understand the risks and rewards in maintaining a with profits policy could be a breach of the FSA's conduct of business requirements;
- Representations made to policyholders during the sales process were to be reflected in the PPFM. This public document should not lead to a change in policyholders expectations;
- The PPFM would be less burdensome and detailed where a firm was less complex or had small with profits liabilities;
- That they would be made available upon request, not as a matter of course;
- Any change in practice by the firm was to be given three months before the effective date before any change could be made in a published principle;
- A firm with more than one PPFM had only to give notice to those policyholders affected;
- Policyholders were entitled to know what a firm's approach to a closure to new business might be and what changes would occur. Any foreseeable risk that would have an impact on the firm's management of it with profits fund had to be covered by the firm;
- Any inherited estate issues and their treatment post closure were to be well defined;

- The PPFM was tied in with realistic reporting for with profits funds as the calculation of realistic liabilities had to be consistent with a firm's actual practice in setting bonus levels and how this was represented to policyholders.

FSA decided that it would not publish a model code of practice for the PPFM. The onus for the PPFM was placed directly on the board of the firm.

52. FSA's most recent consultation paper[7] published shortly before the finalisation of this report has commented further on the development of the PPFM in the context of treating with-profits policyholders fairly. They have found that there are still some areas in with-profits products that could prove to be potentially unfair to consumers and so feel that to counter this, better protection would be offered by new rules and guidance. FSA states that this will cover:

- The determination of amount payable under with-policies, including requiring firms to manage their business;
- An approach to surrender values that should better balance the interests of departing and remaining policyholders;
- Charges to with-profits funds; and
- The basis on which new business must be written.

FSA specified the requirement that firms which stop writing new with-profits business and go into run-off would have to provide adequate information to their policyholders, to make them aware of the options available to them in such a situation. Due to this and the above points, there had been a recognition that firms will need to make changes to their PPFMs to take these new rules into account. With this in mind, it has been indicated that these changes will not become effective until March 31 2005. It has been further decided that companies should present information in their PPFMs to policyholders in an easily understood format, which will subsequently allow firms to dispense with the requirement to produce with-profits guides. It is hoped that the PPFM will address the questions of, and make more transparent, how firms invest their with-profits funds and decide the level of payouts to policyholders. The production of a clear, concise and easily understood PPFM for consumers, derived from a more detailed document is potentially the most important statement to be included in this paper. This proposal should require companies to provide detailed information, in an easily understood format for consumers, on how the fund is managed, the investment mix and liabilities associated with the with profits fund. The key aim, restated again, is to improve transparency.

53. FSA have stated that, to address concern on amounts payable under with-profits policies, they also intend to put forward rules and guidance, for inclusion in the conduct of business handbook. These will aim to address: target ranges for payouts and smoothing, to enable outside parties to distinguish between firms on this basis; the definition of asset share for these purposes; the distribution of surplus, to minimise the risk that firms might underpay or overpay policyholders over time, and surrender values (including the right to apply market value reductions). This latter point should address the question of balance between current and surrendering policyholders. FSA's aim is that surrender values would be derived from premiums received under these policies.

54. FSA have also commented upon proposals they have in mind to improve the reattribution of inherited estates, where applicable, with the aim of ensuring that policyholders receive fair treatment through adequate representation of their interests. By reattribution, they mean that a firm may buy out the rights its policyholders have over the inherited estate, with policyholders giving up the value of what they might receive from a distribution of the estate. The idea of a

[7] Consultation paper 207 – Treating with-profits policyholders fairly – December 2003

policyholder advocate has been put forward, to act in the interests of the policyholders if such a situation were to occur. The firm in question would appoint to this position, but with safeguards in place to ensure that the holder of this position would act in the interests of the policyholder independently of the firm.

55. The charging of costs to a with-profits fund, not directly linked to the fund's operation, is another area that the FSA have indicated they are looking at. They have stated that consultation is ongoing regarding rules to limit charges applied to a fund, to those directly concerning the fund. It has been noted that a key objective of the regulator, and thus requisite for new rules and guidance is to ensure that payouts to policyholders will not be reduced due to costs that may arise from a failure to meet regulatory obligations. FSA have proposed that deduction of any costs from individual's asset share will be an action of last resort.

56. FSA have also indicated their intention to conduct a programme of consumer testing, to ascertain whether information presented in PPFMs, initially proposed in policy statement 167, delivers the greater understanding of with-profits products to consumers that they hope to achieve, prior to it becoming effective in November 2004. It is hoped that this document will contain information enabling policyholders to understand how the firm manages their with-profits business and the effect upon amounts payable under such policies, that it is clearly written and kept up to date. Their ultimate aim is that a reasonable consumer should be able to understand it.

57. Consultation paper 170, dated February 2003, discussed the measures that FSA planned to take to improve the effectiveness of product disclosure of pensions and investment products. The core feature of this would be the key features document (KFD) (the key features document was to replace the key facts document of the previous regulatory regime), which would be made available to a consumer as early into any sales process prior to purchase of any product, thus complying with EU directive requirements. The information detailed in this document would vary with the product sold, i.e. the KFD for a life product would contain an illustration reflecting a consumer's individual circumstance. FSA set out parameters for format, style and content of the new document.

58. Implementation of the proposals the FSA discussed would improve the quality of publicly available information about office practices and financial position as compared with Equitable's communications discussed in this report. In particular, the publication of PPFMs and of performance relative to published principles and practices would ensure that policyholders were informed of the relevant firm's smoothing policies and of the extent of deviation from a firm's published objectives. Over-payment on claims relative to the underlying assets backing with-profits liabilities and future bonus expectations would now be made explicit. But the proposals would be effective only of two conditions were met: effective corporate governance and effective supervision.

Corporate Governance

59. FSA has subjected the governance of with-profits funds to critical review. The Baird report recommended that appointed actuaries be subject to independent external review at a level that would provide comfort equivalent to that provided by an external audit. The committee's view was that while the appointed actuary system had worked well for a long time, reliance on one individual with no external, detailed check of his work inevitably posed risks. The position of Equitable over many years when the Board was ill-equipped to challenge the actuary's advise and form an independent judgment on the actuarial management of the office, has been dealt with at length in this report.

60. FSA's initial response to the Baird report was to note that from 1 December 2001, the approved persons regime would address the issue. They recognised that it was not appropriate for an appointed actuary to hold the responsibilities of another senior role within a company. They stated their intention to address this area further, noting that they would have assistance from the actuarial profession. In

January 2003, consultation paper 167, dealing with governance, the role of actuaries generally, and certification of financial statements was published. The aim of this paper was to set out proposals to improve transparency; strengthen governance of insurance firms; and simplify certification of returns.

61. Proposals were put forward for the discontinuance of the existing appointed actuary regime, and the introduction of two new actuarial functions; a new general actuarial function applicable to all insurers, and a specific with-profits actuarial function, both of which would be controlled functions. It was stated that boards and senior management would take overall responsibility for the actuarial aspects of the business. It would be for the directors to satisfy themselves concerning the reserves a company held, and that liabilities were valued appropriately. Both areas would be brought within the scope of the audit. Directors would be required to take decisions on all key areas relating to the soundness of the firm, obtaining actuarial advice where appropriate. There would be a change to the regulatory regime to underline the responsibilities on firms' directors for the valuation of policyholder liabilities. The new with-profits actuarial function was intended to remove any tensions between policyholders and shareholder interests. The appointed actuary had personal responsibility under the current regime to advise on the use of discretion when establishing amounts payable to policyholders, and an equivalent was required. It was intended that regulatory responsibility would be focused on policyholder interests.

62. FSA stated that firms writing long term business would be required to set up an actuarial function to advise senior management on a range of issues, especially liability valuation. They specified that the holder of this office would be a member of Faculty or Institute of Actuaries, and an approved person under the Financial Services and Markets Act. The role of the with-profits actuary would be similar. Firms would decide where responsibilities lay, where there was potential for overlap between the two roles. Both actuarial functions would be subject to whistle-blowing requirements if HMT introduced regulations under section 340 of Financial Services and Markets Act. FSA supported the introduction of these regulations.

63. To help avoid conflicts between the two actuarial functions, FSA proposed that a possible solution would be:

- To make the with-profits actuary independent of the firm. This would enable independent advice but could lead to lower levels of involvement with the firm and a lesser understanding of the firms business; and
- Where the with-profits actuary or anyone performing both actuarial functions was a member of the firm, they would not be allowed to be a member of the board.

64. It was also proposed that directors and senior management be more responsible for setting up technical provisions and other decisions taken on actuarial advice. The requirements for certification of financial statements would change to reflect the new proposals. FSA identified as a weakness of the current regime, the restricted requirement of directors that they certified explicitly some aspects of the returns but not others. One aspect of the revision of the certification process was that it would include the actuarial investigation, presently certified by the appointed actuary. It was proposed that directors take explicit responsibility for all aspects of the regulatory returns.

65. The director's certificate would include a management report, similar to the director's report in the Companies Act accounts, and a directors' certificate. The management report would apply to life insurers only and would be a narrative report. The information required would be that already required in the actuary's abstract report in current practice. It was noted that there would be a reduction in the amount of information reported. The report would be divided into sections to allow users to see clearly the information that applied to specified areas. The aim was to make the directors' certificate more streamlined than the current certificate,

similar to the current actuarial certificate. This would be the same for life and non-life firms, excepting specific statements for special aspects of the life business.

66. The scope of the audit would extend to include the valuation of policyholder liabilities and other aspects of the regulatory return that were previously the responsibility of the appointed actuary, due to concern that without independent work, the appointed actuary did not benefit from the challenge of other actuaries and other professionals with relevant experience. FSA proposed to require auditors of life firms to obtain a report from an actuary on the valuation of policyholder liabilities as part of the audit work. An actuary independent of the firm and its actuarial function would provide this advice. Rewording of the audit contract would bring it into line with Companies Act requirements. That would ensure that the regulatory returns approach would come into line with the approach in the Companies Act accounts.

67. Feedback on consultation paper 167 led to some amendment of the proposals that had been previously put forward. With respect to the with-profit actuary's report to policyholders, FSA proposed that the scope of the with-profit actuary's duties would include producing a statement to accompany the annual report to policyholders, to state whether in his opinion, based on information supplied by the firm, the firm's report and the discretion exercised during the period under review could be regarded as having taken policyholders interests into account in a reasonable and proportionate manner. The proposal to annex the with-profits actuary's report to the firm's own report would come into effect when the new actuarial roles came into effect.

68. Regarding the future role of actuaries, changes in emphasis of the initial proposals were noted as a result of the feedback. FSA noted that:

- While they remained of the view that it should be permissible for an individual to perform the roles of the with-profits actuary and the actuarial function, firms should have the ability to have different people performing the two roles, recognising that the with-profits actuary's advice was focused on the fair treatment of policyholders and represented the expectations and interests of policyholders.
- The with-profits actuary, and any actuary performing both roles, should not be a member of the board but should have the right to attend board meetings. An actuarial function holder performing only this role could be a member of the board. The actuarial function holder's scope was widened to require the officer to monitor the financial condition of the firm and advise on capital needed to support the business.
- The with-profits actuary would report to the board, at least annually, on key aspects of the discretion exercised during the year, including any issues affecting the PPFM. The board would have a duty to keep the with-profits actuary informed of all relevant aspects of the business.
- The with-profits actuary would have to state whether, on the information supplied, the discretion the board exercised during the review period could be regarded as having taken policyholders' interests into account in a reasonable and proportionate manner.
- Where schemes of arrangement or other documents delegated certain duties to the appointed actuary, firms would need to put in place alternative arrangements. The with-profits actuary or the actuarial function might carry out these duties.
- The reviewing actuary should provide a published opinion on the valuation of policyholder liabilities.

69. FSA produced and published a document entitled the "With Profits Governance Instrument 2003". This detailed an amendment to the conduct of business sourcebook, namely the inclusion of rules that dealt with the application

and purpose of the Principles and Practices of Financial Management coming into force on 31 March 2004. The amendments to sourcebook included rules dealt in detail with the firm's requirement to pay due regard to the interests of its customers and treat them fairly. It also noted the provision that a firm's PPFM must cover their approach to smoothing the value of its with profit policies. It was noted that the firm's with-profits principles should:

- Indicate whether and in what respect a firm took a significantly different approach to smoothing depending on the type of claim arising from with profits policies;
- Indicate whether smoothing was to be neutral over time;
- Indicate whether there was any total scale or cost of smoothing to the firm over the shorter term that a firm believed should not be exceeded; and
- Indicate whether the firm applied market value adjusters or changed the surrender bases for with-profits policies that were not unitised only to reflect changes in the underlying asset values.

70. Proposals for reporting and audit for firms within the scope of the enhanced capital requirement were refined further, and there was further consultation on two new reporting forms to support the assessment of capital for with-profits business under the twin peaks approach. Two new forms would be introduced, forms 18 and 19 with subsequent amendments to the present form 9. An earlier consultation paper[8] proposed a form 9B to show the effects of financial engineering on the with-profits fund. However, this was postponed following further consultation until a more appropriate realistic presentation had been developed. FSA's draft rules and guidance addressed these concerns: form 19 would fulfil the intended aim of form 9B by providing a clear picture of the realistic solvency position of a with profits fund, including the effect of any financial engineering. Forms 18 and 19 would form part of a firm's annual reporting requirement and so would be publicly disclosed. It was also proposed that firms would disclose the assumptions underlying the calculation of their realistic liabilities and risk capital margin. Forms 18 and 19 would be submitted with a full valuation report annually, and at the firm's own financial year-end. Half-year reporting would be to the regulator only. FSA stated that these changes would be brought in and made effective in 2004.

71. In the case of Equitable:

- Delegation of liability valuation and management to the Actuary without adequate (or for most of the reference period any) supervision by the Board or its committees created a gap in governance that allowed the Actuary to pursue policies that the Board accepted uncritically.
- Those policies led to a situation in which the Society was unacceptably weak and could not sustain the shock of an emerging liability that ought to have been within its capacity to absorb as a going concern.
- The combination in one individual of the internal and appointed actuarial functions and the position of chief executive created a position of dependence at Board level that was fatal to the interests of sound management of the business.
- Except in relation to its listed debt, Equitable, as a mutual, was affected by Cadbury and other codes only to the extent that it adopted them voluntarily.
- Equitable was not subject to any degree of effective policyholder influence.

[8] Consultation paper 144 - A new regulatory approach to insurance firms' use of financial engineering – August 2002

72. The FSA's proposals would deal with the first and third points. Some observations on the general scope of the proposals could be made. But if, in their present form or as further developed, they deal adequately with the problems inherent in the former regime; they will cover the governance deficiencies at board and management level that the inquiry has sought to identify in Equitable. Their proposals do not cover points four and five.

Director's Certificate and Audit

73. Consultation paper 202 of September 2003 re-opened consultation on changes to the director's certificate and audit. As set out in consultation paper 167, the proposed changes reflected the FSA's objective of making directors more explicitly responsible for setting up technical provisions and for other decisions taken on actuarial advice. New audit requirements for policyholder liabilities were proposed plus changes to the returns affecting all insurers.

74. The proposals for the directors' certificate and audit have been expanded from the proposals first put forward in consultation paper 167. After feedback on the certification of returns, the FSA proposed that the directors' certificate should include confirmation that directors had taken actuarial advice from the actuarial function holder on the valuation of policyholder liabilities and that they had paid due regard to it. FSA proposed the requirement that the reviewing actuary produce an opinion whether, and for the directors' to certify that, they had received actuarial advice and paid due regard to it. FSA further proposed that the audit opinion be amended to remove reporting on the directors' certificate from the scope of the opinion, thus incurring no additional audit costs in respect of the directors' certificate. In this paper, FSA noted that a re-worded report would provide assurance on all financial data on the full balance sheet and solvency calculation within the annual return, and give an opinion on whether the statements in the directors' certificate and valuation report were consistent with the audited financial data in the regulatory return.

75. One of the aims of the FSA's new approach is to try to align the information of the Companies Act accounts and the annual regulatory returns, in that the financial forms would be consistent with the accounts and the valuation report within the director's report. This would enable reconciliation between the two in terms of increasing the transparency of the figures presented. They also stated in this paper, their intention to widen the scope of the audit review to cover areas of the annual regulatory return that previously came under the scope and responsibility of the appointed actuary, enabling independent scrutiny. Another proposal they have made is the requirement that auditors of life firms obtain a report from an independent actuary (i.e. not an employee or consultant directly retained by the firm), as a standard element of the audit, on the valuation of the firm's policyholder liability. The actuary advising the auditor would then review this. Upon completion of this review, the reviewing actuary would then be required to issue a personal opinion on the validity of the assumptions used and that the reserves have been calculated in line with these assumptions, that reserves meet the firm's regulatory requirement and that the firm's solvency margin has been similarly calculated. This personal opinion would then be produce in parallel with the audit report.

76. They further note that any future reporting requirements will be based around any future international accounting standards and Solvency II directive proposals, when they come into effect. They have stated that they expect this directive to introduce more risk based capital requirements and a greater regulatory emphasis on, amongst other areas, risk management and internal control and that their regulatory requirement will reflect this directive once it comes into force.

Implementation

77. FSA conducted a survey of life insurer's risk management practices in October 2003 and noted that their guidance and proposals have, to some extent, been implemented within this sector of the insurance industry. They have highlighted

however that most of the changes firms have introduced to their practices have been done in a reactive rather than proactive manner, following the guidance rather than understanding what is required and not looking closely enough at their own existing systems before instigating the changes. Firms are increasing their levels of modelling activity, taking on external assistance where necessary. They have indicated though that communication between certain functions within firms has not improved and this could result in unsuitable modelling scenarios, which could hinder alignment of risk with capital. On the whole, it appears that their ever-evolving guidance has been welcomed and adopted by firms in general, but FSA note that they still are concerned that measures introduced are not implemented solely to meet compliance requirements.

Abridged Society Profit & Loss Account A

Society Profit and Loss Account: 1960 to 1969[1] **[Table A.1]**

	1960 £m	1961 £m	1962 £m	1963 £m	1964 £m	1965 £m	1966 £m	1967 £m	1968 £m	1969 £m
Income										
Premiums	4	5	5	7	7	8	9	10	10	10
Investment income	2	2	2	3	4	4	5	5	6	7
Total Income	6	7	7	9	11	12	13	15	15	17
Expenditure										
Claims	3	3	3	3	3	3	4	5	5	6
Commissions	-	-	-	-	-	-	-	-	-	-
Expenses of management	0	0	0	0	0	0	1	1	1	1
Taxation	0	0	0	0	1	1	1	1	2	1
Total Expenditure	3	3	4	3	5	5	6	7	7	8
Surplus of income over expenditure	**3**	**3**	**3**	**6**	**6**	**7**	**8**	**8**	**8**	**9**
Appreciation in value of investments treated as surplus	-	1	-	-	1	-	-	1	-	-
Net addition to the fund	**3**	**5**	**3**	**6**	**7**	**7**	**8**	**9**	**8**	**9**
Fund at the beginning of the year	36	39	44	47	52	59	66	74	83	91
FUND AT THE END OF THE YEAR	**39**	**44**	**47**	**52**	**59**	**66**	**74**	**83**	**91**	**99**

[1] The Equitable Life Assurance Society: Report and Accounts 1960 to 1969

Abridged Society Profit & Loss Account

A

Society Profit and Loss Account: 1970 to 1981[2] [Table A.2]

	1970 £m	1971 £m	1972 £m	1973 £m	1974 £m	1975 £m	1976 £m	1977 £m	1978 £m	1979 £m	1980 £m	1981 £m
Income												
Premiums	12	15	18	20	23	25	37	39	60	73	93	121
Investment income	7	8	9	11	13	16	19	24	29	39	50	62
Total Income	19	24	27	31	36	41	56	63	89	112	143	183
Expenditure												
Claims	6	7	9	10	12	13	20	21	23	23	26	34
Commissions	-		-	-	-	-	-	-	-		-	-
Expenses of management	1	1	1	2	2	3	4	5	6	8	10	12
Taxation	2	2	2	2	2	3	3	2	2	2	2	3
Total Expenditure	9	10	12	14	16	19	27	28	31	32	38	49
Surplus of income over expenditure	**11**	**14**	**16**	**17**	**19**	**21**	**29**	**35**	**58**	**80**	**104**	**134**
Appreciation in value of investments treated as surplus	3		-	12	-	-	0	-	-	15	-	-
Net addition to the fund	**14**	**14**	**16**	**29**	**19**	**21**	**29**	**35**	**58**	**95**	**104**	**134**
Provision for unrealised diminution in value of investment	-	-	-	-	37	(37)	-	-	-	-	-	-
Fund at the beginning of the year	99	113	127	143	172	154	213	242	277	335	430	534
FUND AT THE END OF THE YEAR	**113**	**127**	**143**	**172**	**154**	**213**	**242**	**277**	**335**	**430**	**534**	**668**

[2] The Equitable Life Assurance Society: Report and Accounts 1970 to 1981

Abridged Society Profit & Loss Account A

Society Profit and Loss Account: 1982 to 1993[3] **[Table A.3]**

	1982 £m	1983 £m	1984 £m	1985 £m	1986 £m	1987 £m	1988 £m	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
Income												
Premiums	157	219	263	304	398	500	622	1,040	1,345	1,715	1,877	2,101
Investment income	79	95	117	150	169	201	237	298	376	459	572	668
Total Income	235	314	380	453	568	701	859	1,339	1,722	2,174	2,448	2,769
Expenditure												
Claims	53	77	91	112	161	225	293	472	659	839	946	1,122
Commissions	-	-	-	-	-	-	-	-	-	-	-	-
Expenses of management	15	20	25	29	34	42	62	88	102	124	124	121
Other	0	0	0	0	0	1	0	0	0	3	1	1
Taxation	(2)	3	3	4	11	8	5	(2)	6	1	7	20
Total Expenditure	66	100	119	145	205	276	360	558	768	967	1,079	1,263
Surplus of income over expenditure	**169**	**214**	**261**	**308**	**363**	**425**	**499**	**781**	**954**	**1,208**	**1,370**	**1,506**
Change in value of linked assets	0	4	6	11	17	7	17	62	(82)	24	56	203
Appreciation in value of investments treated as surplus	45	-	-	125	115	125	167	317	0	185	144	1,179
Net addition to the fund	**214**	**218**	**267**	**444**	**495**	**557**	**682**	**1,159**	**872**	**1,417**	**1,569**	**2,889**
Fund at the beginning of the year	668	882	1,099	1,367	1,811	2,305	2,862	3,545	4,704	5,576	6,993	8,562
FUND AT THE END OF THE YEAR	**882**	**1,099**	**1,367**	**1,811**	**2,305**	**2,862**	**3,545**	**4,704**	**5,576**	**6,993**	**8,562**	**11,451**

[3] The Equitable Life Assurance Society: Report and Accounts 1982 to 1993

Abridged Society Profit & Loss Account

A

Society Profit and Loss Account: 1993 (restated) to 2000[4]

[Table A.4]

Technical Account: Long-term Business	**1993 £m**	**1994 £m**	**1995 £m**	**1996 £m**	**1997 £m**	**1998 £m**	**1999 £m**	**2000 £m**
	Restated[5]							
Premiums	2,101	2,052	2,362	2,830	3,452	3,730	3,484	2,941
Investment income	975	853	1,132	1,395	1,325	1,787	1,957	2,653
Unrealised gains on investment	1,883	0	1,132	374	2,046	1,670	2,314	0
Other technical income	0	0	6	7	7	9	15	16
Total Income	**4,958**	**2,905**	**4,632**	**4,606**	**6,831**	**7,195**	**7,770**	**5,610**
Claims	1,128	1,114	1,433	1,741	2,228	2,547	2,692	3,063
Value of benefits excluding new declared bonus	2,280	477	1,852	1,874	2,929	2,486	1,564	2,692
New declared bonus	318	350	417	504	508	363	423	0
Long-term business provision: net amount	2,597	826	2,269	2,378	3,437	2,849	1,987	2,692
Technical provision for linked liabilities	292	102	264	294	513	686	1,069	317
Changes in other technical provisions: net of reinsurance	2,889	928	2,533	2,672	3,950	3,535	3,056	3,009
Net operating expenses	98	98	98	104	118	133	143	273
Commissions	-	-	-	-	-	-	-	-
Investment expenses and charges	6	6	10	11	23	39	37	43
Unrealised losses on investment	0	1,537	0	0	0	0	0	1,710
Taxation	20	12	28	46	66	93	20	43
Transfer to (from) the fund for future appropriations	817	(790)	530	32	447	849	1,823	(2,530)
	941	863	666	193	653	1,114	2,022	(462)
Total	**4,958**	**2,905**	**4,632**	**4,606**	**6,831**	**7,195**	**7,770**	**5,610**
Balance on Technical Account	0	0	0	0	0	0	0	0

[4] The Equitable Life Assurance Society: Report and Accounts 1993 (restated) to 2000

[5] The restated 1993 figures contained in the 1994 Report and Accounts have been disclosed for comparative purposes.

Abridged Society Balance Sheet

B

Society Balance Sheet: 1960 to 1969[6]

[Table B.1]

	1960 £m	1961 £m	1962 £m	1963 £m	1964 £m	1965 £m	1966 £m	1967 £m	1968 £m	1969 £m
Investments[7]	39	43	46	52	59	67	74	82	90	99
Current assets	1	1	1	1	1	1	1	2	2	2
Total assets	39	44	47	53	60	68	75	84	92	101
Current liabilities	0	1	1	1	1	2	1	1	1	1
Net assets	**39**	**44**	**47**	**52**	**59**	**66**	**74**	**83**	**91**	**99**
Long-term business fund	**39**	**44**	**47**	**52**	**59**	**66**	**74**	**83**	**91**	**99**

[6] The Equitable Life Assurance Society: Report and Accounts 1960 to 1969
[7] Investments were valued at the lower of cost, written up for capital appreciation treated as surplus, or net realisable value.

Abridged Society Balance Sheet

B

Society Balance Sheet: 1970 to 1981[8] **[Table B.2]**

	1970 £m	1971 £m	1972 £m	1973 £m	1974 £m	1975 £m	1976 £m	1977 £m	1978 £m	1979 £m	1980 £m	1981 £m
Investments (refer to note below)	114	127	142	171	153	210	239	270	329	421	523	654
Current assets	2	3	4	4	3	4	5	10	12	15	18	22
Total assets	116	130	145	175	156	215	244	280	341	435	541	676
Current liabilities	2	3	3	3	2	2	2	4	6	6	7	8
Net assets	**113**	**127**	**143**	**172**	**154**	**213**	**242**	**277**	**335**	**430**	**534**	**668**
Long-term business fund	**113**	**127**	**143**	**172**	**154**	**213**	**242**	**277**	**335**	**430**	**534**	**668**
Note:												
Disclosed investment market value[9]	-	164	194	190	154	213	241	333	389	454	608	741
Off balance sheet reserves[10]	-	37	52	19	1	3	2	63	60	33	85	87
Off balance sheet reserve:												
Opening position[11]	-	-	36.6	52.1	18.6	0.9	2.6	2.1	62.6	60.1	33.3	84.9
Movement	-	-	15.5	(21.5)	(17.7)	1.7	(0.5)	60.5	(2.5)	(11.8)	51.6	1.9
Capital appreciation treated as surplus	-	-	-	(12.0)	-	-	0.0	-	-	(15.0)	-	-
Closing position	-	**36.6**	**52.1**	**18.6**	**0.9**	**2.6**	**2.1**	**62.6**	**60.1**	**33.3**	**84.9**	**86.8**

[8] The Equitable Life Assurance Society: Report and Accounts 1970 to 1981
[9] The Society first disclosed the market values of its investments (including the 1971 comparative figure) in 1972 Report and Accounts.
[10] The off balance sheet reserve is calculated by deducting the book value of investments from their disclosed market values.
[11] Analysis for the years prior to 1971 was not possible due to the information not being available from the published information.

Abridged Society Balance Sheet

B

Society Balance Sheet: 1982 to 1993[12] [Table B.3]

	1982 £m	1983 £m	1984 £m	1985 £m	1986 £m	1987 £m	1988 £m	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
Investments at market value[13]	1,085	1,426	1,806	2,213	2,840	3,356	4,109	5,661	5,759	7,263	9,334	13,131
Current assets	39	46	77	77	81	92	123	143	185	216	283	233
Total assets	1,124	1,472	1,883	2,290	2,921	3,448	4,232	5,804	5,944	7,480	9,617	13,364
Current liabilities	39	35	49	43	36	62	69	99	158	112	120	172
Net assets	**1,086**	**1,437**	**1,833**	**2,246**	**2,885**	**3,386**	**4,163**	**5,705**	**5,786**	**7,368**	**9,497**	**13,192**
Long-term business fund	882	1,099	1,367	1,811	2,305	2,862	3,545	4,704	5,576	6,993	8,562	11,451
Investment reserve[14]	204	337	467	436	580	524	618	1,001	210	375	935	1,741
Total fund value	**1,086**	**1,437**	**1,833**	**2,246**	**2,885**	**3,386**	**4,163**	**5,705**	**5,786**	**7,368**	**9,497**	**13,192**

[12] The Equitable Life Assurance Society: Report and Accounts 1982 to 1993

[13] In 1982 the Society changed its investment accounting policy to carry investments at their market values.

[14] The effect of the Society's investment accounting policy change resulted in the previous 'off balance sheet reserve' coming on balance sheet from 1982 and being reflected within the Investment Reserve.

Abridged Society Balance Sheet

B

Society Balance Sheet: 1993 (restated) to 2000[15] **[Table B.4]**

	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
	Restated[16]							
Investments at market value	12,113	12,112	14,889	17,028	21,199	24,902	28,671	29,263
Assets held to cover linked liabilities[17]	1,000	1,084	1,351	1,903	2,422	3,113	4,185	4,516
Total investments	13,113	13,196	16,240	18,931	23,621	28,016	32,856	33,779
Current assets	465	566	527	515	582	630	639	696
Total assets	13,578	13,763	16,767	19,446	24,203	28,646	33,494	34,475
Subordinated liabilities[18]	0	0	0	0	346	346	346	346
Current liabilities	171	218	155	138	176	226	240	576
Net assets	**13,407**	**13,545**	**16,612**	**19,309**	**23,681**	**28,073**	**32,908**	**33,553**
Long-term business provision	10,462	11,289	13,561	15,680	19,096	21,954	23,905	26,611
Claims outstanding	0	0	0	0	0	0	0	150
Technical provision for linked liabilities	981	1,083	1,346	1,896	2,408	3,094	4,162	4,481
Technical provisions	11,443	12,371	14,907	17,576	21,504	25,048	28,067	31,242
Fund for future appropriations[19]	1,964	1,174	1,705	1,733	2,176	3,025	4,841	2,311
Total fund value	**13,407**	**13,545**	**16,612**	**19,309**	**23,681**	**28,073**	**32,908**	**33,553**

[15] The Equitable Life Assurance Society: Report and Accounts 1993 (restated) to 2000
[16] The restated 1993 figures contained in the 1994 Report and Accounts have been disclosed for comparative purposes.
[17] The Society's Report and Accounts first disclosed its unit-linked business separately from 1994.
[18] Refer to the Notes to the Financial Tables: Table I - 1.1
[19] The Society's Investment Reserve was in effect superseded from 1994 by the Fund for Future Appropriations.

Financial and Ratio Analysis

C

Financial and Ratio Analysis: 1960 to 1969 **[Table C.1]**

	1960 £m	1961 £m	1962 £m	1963 £m	1964 £m	1965 £m	1966 £m	1967 £m	1968 £m	1969 £m
Financial Analysis:										
Premium growth: annual	-	0.8	-0.2	2.1	0.7	0.3	1	0.9	0.1	0.8
Premium growth: triennium	-	-	-	-	2.6			2.2		
Gross Premiums [Mix]	3.9	4.7	4.5	6.6	7.3	7.6	8.6	9.5	9.6	10.4
Existing business	3.0	3.6	3.4	4.6	4.9	5.5	6.4	7.3	7.5	8.0
New business	0.9	1.1	1.1	2.0	2.4	2.1	2.2	2.2	2.1	2.4
Net asset growth: annual	-	5	3	6	7	7	8	9	8	9
Net asset growth: triennium	-	-	-	-	16	-	-	24	-	-
Ratio Analysis:										
Premium growth[20]	-	21%	-4%	47%	11%	4%	13%	10%	1%	8%
Gross Premiums [% Mix]										
Existing business	77%	77%	76%	70%	67%	72%	74%	77%	78%	77%
New business	23%	23%	24%	30%	33%	28%	26%	23%	22%	23%
Investment income growth[21]	-	11%	10%	14%	44%	14%	15%	13%	9%	12%
Claims/ fund value[22]	6%	7%	7%	6%	6%	5%	6%	7%	6%	6%
Management expense ratio[23]	5%	6%	7%	5%	5%	5%	6%	5%	6%	7%
Investment yield[24] (estimated)	4.9%	4.9%	4.9%	5.1%	6.5%	6.5%	6.7%	6.8%	6.7%	6.9%
Net assets growth - annual[25]	-	12%	7%	12%	13%	12%	11%	12%	10%	10%
Net assets growth - triennial	-	-	-	-	36%	-	-	40%	-	-

[20] Premium growth: the percentage year-on-year movement in premium income (Ref. Table A) divided by the base year's premium income.
[21] Investment income growth: the percentage year-on-year movement in investment income (Ref. Table A) divided by the base year's investment income.
[22] The years claims value (Ref. Table A) is divided by the Long-term business fund or Total fund value (Ref. Table B) and the result expressed as a percentage.
[23] The management expense ratio represents the expenses of management or net operating expenses (Ref. Table A) expressed as a percentage of premium income.
[24] The investment yield represents either the years reported yield, as disclosed in the Society's Report and Accounts, or the yield is calculated by dividing the current years investment income (Ref. Table A) by the average investment value for the year (Ref. Table B).
[25] Net asset growth: the percentage year-on-year/triennium movement in net assets (Ref. Table B) divided by the base year's net assets.

Financial and Ratio Analysis

C

Financial and Ratio Analysis: 1970 to 1981 **[Table C.2]**

	1970 £m	1971 £m	1972 £m	1973 £m	1974 £m	1975 £m	1976 £m	1977 £m	1978 £m	1979 £m	1980 £m	1981 £m
Financial Analysis:												
Premium growth: annual	1.7	3.3	2.6	2.2	2.5	2.1	11.8	2.1	20.9	13.7	19.3	28.1
Premium growth: triennium	2.6	-	-	8.1	-	-	16.4	-	-	36.7	-	-
Gross Premiums [Mix]	12.0	15.4	18.0	20.2	22.7	24.8	36.6	38.8	59.6	73.3	92.6	120.7
Existing business	9.0	11.6	12.7	14.9	15.7	18.2	28.4	28.8	41.4	52.7	65.5	85.4
New business	3.0	3.8	5.3	5.3	7.0	6.6	8.2	10.0	18.2	20.6	27.1	35.3
Net asset growth: annual	14	14	16	29	-18	58	29	35	58	95	104	134
Net asset growth: triennium	31	-	-	59	-	-	70	-	-	188	-	-
Ratio Analysis:												
Premium growth	-	27%	17%	12%	12%	9%	48%	6%	54%	23%	26%	30%
Gross Premiums [% Mix]												
Existing business	75%	75%	71%	74%	69%	73%	78%	74%	69%	72%	71%	71%
New business	25%	25%	29%	26%	31%	27%	22%	26%	31%	28%	29%	29%
Investment income growth	-	28%	10%	17%	5%	16%	56%	1%	44%	27%	24%	30%
Claims/ fund value	5%	6%	6%	6%	8%	6%	8%	8%	7%	5%	5%	5%
Management expense ratio	7%	6%	6%	7%	10%	12%	11%	13%	10%	11%	11%	10%
Investment yield	7.0%	7.2%	7.2%	6.3%	7.3%	8.0%	8.8%	9.8%	10.0%	10.7%	10.9%	10.9%
Net assets growth - annual	14%	12%	12%	21%	-10%	38%	14%	14%	21%	28%	24%	25%
Net assets growth - triennial	37%	-	-	52%	-	-	40%	-	-	78%	-	-
Solvency ratio[26]	-	28%	36%	11%	1%	1%	1%	22%	18%	8%	16%	13%
Total Liabilities / Total Assets & Reserves[27]	-	78%	74%	90%	99%	99%	99%	82%	85%	93%	86%	89%

[26] Solvency is calculated by dividing the off balance sheet reserves by the long-term business fund (Ref. Table B.2). Implicit inner reserves held in liabilities are ignored for the purposes of this ratio.
[27] Total liabilities are divided by total assets and off balance sheet reserves (Refer. Table B.2).

Financial and Ratio Analysis

C

Financial and Ratio Analysis: 1982 to 1993 **[Table C.3]**

Financial Analysis:	**1982 £m**	**1983 £m**	**1984 £m**	**1985 £m**	**1986 £m**	**1987 £m**	**1988 £m**	**1989 £m**	**1990 £m**	**1991 £m**	**1992 £m**	**1993 £m**
Premium growth: annual	35.8	62.9	43.7	40.6	94.5	101.6	121.8	418.6	305.2	370	161.2	224.2
Premium growth: triennium	83.2	-	-	147.2	-	-	-	-	-	-	-	-
Gross Premiums [Mix]	157	219	263	304	402	502	680	1,042	1,345	1,715	1,877	2,101
Regular	132	172	218	252	298	370	549	634	767	880	945	1,013
Single	24	48	45	52	104	132	131	408	578	835	932	1,088
New Business [Mix]	69	114	124	137	205	265	321	642	836	1,117	1,226	1,411
Regular	45	66	79	85	101	133	190	234	258	282	294	323
Single	24	48	45	52	104	132	131	408	578	835	932	1,088
Net asset growth: annual	418	351	397	413	639	501	777	1,542	81	1,581	2,129	3,695
Net asset growth: triennium	656	-		1,161	-	-	-	-	-	-	-	-
Ratio Analysis:												
Premium growth	30%	40%	20%	15%	31%	26%	24%	67%	29%	28%	9%	12%
Gross Premiums [% Mix]												
Regular	84%	79%	83%	83%	74%	74%	81%	61%	57%	51%	50%	48%
Single	15%	22%	17%	17%	26%	26%	19%	39%	43%	49%	50%	52%
New Business [% Mix]												
Regular	65%	58%	64%	62%	49%	50%	59%	36%	31%	25%	24%	23%
Single	35%	42%	36%	38%	51%	50%	41%	64%	69%	75%	76%	77%
Investment income growth	26%	21%	23%	28%	13%	19%	18%	26%	26%	22%	25%	17%
Claims/ fund value	4.9%	5%	5%	5%	6%	7%	7%	8%	11%	11%	10%	9%
Management expense ratio	9.4%	9.2%	9.4%	9.6%	8.4%	8.5%	9.9%	8.5%	7.6%	7.2%	6.6%	5.8%
Investment yield	11.0%	10.0%	9.9%	7.4%	6.7%	6.5%	6.4%	6.1%	6.6%	7.1%	6.9%	6.0%
Net assets growth - annual	63%	32%	28%	23%	28%	17%	23%	37%	1%	27%	29%	39%
Net assets growth - triennial	153%	-	-	107%	-	-	-	-	-	-	-	-
Solvency ratio[28]	22%	30%	33%	24%	25%	18%	17%	21%	4%	5%	-11%	15%
Total Liabilities / Total Assets[29]	82%	77%	75%	81%	80%	85%	85%	83%	96%	95%	90%	87%

[28] Solvency is calculated by dividing the Investment Reserve by the Total Fund (Ref. Table B.3). Implicit inner reserves held in liabilities are ignored for the purposes of this ratio.

[29] Total liabilities are divided by total assets (Ref. Table B.3).

Financial and Ratio Analysis

C

Financial and Ratio Analysis: 1993 (restated) to 2000 **[Table C.4]**

	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Financial Analysis:	Restated							
Premium growth: annual	224	-49	310	469	622	277	-246	-543
Gross Premiums [Mix]	2,102	2,053	2,364	2,832	3,455	3,733	3,488	2,946
Regular	1,015	1,018	1,074	1,242	1,505	1,556	1,510	1,431
Single	1,087	1,035	1,290	1,590	1,950	2,177	1,978	1,515
New Business [Mix]	1,410	1,344	1,616	2,005	2,444	2,596	2,320	1,795
Regular	323	309	326	415	494	419	342	280
Single	1,087	1,035	1,290	1,590	1,950	2,177	1,978	1,515
Net asset growth: annual	3,910	138	3,067	2,697	4,372	4,393	4,835	645
Ratio Analysis:								
Premium growth	12%	-2%	15%	20%	22%	8%	-7%	-16%
Gross Premiums [% Mix]								
Regular	48%	50%	45%	44%	44%	42%	43%	49%
Single	52%	50%	55%	56%	56%	58%	57%	51%
New Business [% Mix]								
Regular	23%	23%	20%	21%	20%	16%	15%	16%
Single	77%	77%	80%	79%	80%	84%	85%	84%
Investment income growth	13%	-2%	17%	19%	22%	12%	-5%	-15%
Claims/ fund value	8%	8%	9%	9%	9%	9%	8%	9%
Management expense ratio	4.7%	4.8%	4.2%	3.7%	3.4%	3.6%	4.1%	9.3%
Investment yield (estimated)	5.6%	5.6%	5.0%	5.6%	5.0%	4.5%	3.9%	3.7%
Net assets growth - annual	2%	3%	23%	16%	23%	19%	17%	2%
Solvency ratio[30]	17%	9%	11%	10%	10%	12%	17%	7%
Total Liabilities / Total Assets	86%	91%	90%	91%	91%	89%	86%	93%

[30] Solvency is calculated by dividing the Fund for Future Appropriations by the Total Fund (Ref. Table B.4). With effect from 1994, all reserves are explicitly held in the Society's Funds for Future Appropriations.

Bonus Distribution

D

Bonus Distribution [Table D.1]

Allocations	**1973 £m** Triennium [31]	**1976 £m** Triennium	**1979 £m** Triennium	**1982 £m** Triennium	**1985 £m** Triennium	**1986 £m** Annual	**1987 £m** Annual	**1988 £m** Annual
Actual investment return	40.3%	17.1%	50.2%	66.1%	53.9%	20.6%	8.9%	15.1%
Allocated as follows:								
Roll-up rate	9.0%	9.5%	10.5%	10.5%	10.5%	3.5%	3.5%	3.5%
Declared bonus	19.5%	19.5%	21.0%	21.0%	27.8%	8.5%	7.5%	7.5%
Guaranteed allocation	28.5%	29.0%	31.5%	31.5%	38.3%	12.0%	11.0%	11.0%
Investment yield	20.7%	24.1%	30.5%	32.8%	27.3%	6.7%	6.5%	6.4%
Income (shortfall) surplus[32]	-7.8%	-4.9%	-1.0%	1.3%	-11.0%	-5.3%	-4.5%	-4.6%
Profit & Loss Account treatment:								
Capital appreciation recognised and treated as surplus	£12m	£0m	£15m	£45m	£125m	£115m	£125m	£167m
Smoothing analysis:								
3 year smoothed return	40%	17%	50%	66%	54%	17%	14%	15%
Less: Guaranteed allocation	29.5%	29.0%	31.5%	31.5%	38.3%	12.0%	11.0%	11.0%
Less: Management expense %[33]	2.0%	4.7%	5.3%	5.3%	4.6%	1.3%	1.4%	1.7%
Available excess (shortfall)[34]	10%	-17%	13%	29%	11%	4%	2%	2%

[31] Figures between 1973 and 1985 represent aggregated triennial values, 1986 to 1988 are annual values.
[32] The computed % income (shortfall) surplus is before management expenses.
[33] Management expenses expressed as a % of the average investment market value for the year.
[34] Residual unallocated investment returns available for current year and future terminal bonus payments.

Bonus Distribution D

Bonus Distribution **[Table D.2]**

	1971 £m	1972 £m	1973 £m	1974 £m	1975 £m	1976 £m	1977 £m	1978 £m	1979 £m
Roll-up rate	3.0%	3.0%	3.0%	3.0%	3.0%	3.5%	3.5%	3.5%	3.5%
Declared bonus	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	7.0%	7.0%	7.0%
Guaranteed allocation	9.5%	9.5%	9.5%	9.5%	9.5%	10.0%	10.5%	10.5%	10.5%
Terminal bonus[35]	-	-	1.0%	1.3%	1.3%	1.3%	1.0%	1.0%	1.0%
Total growth rate allocated[36]	9.5%	9.5%	10.5%	10.8%	10.8%	11.3%	11.5%	11.5%	11.5%
Actual investment return	29.9%	16.9%	-6.5%	-27.8%	36.7%	8.2%	38.0%	7.3%	4.9%
Under (Over) allocation	20.4%	7.4%	-17.0%	-38.6%	25.9%	-3.1%	26.5%	-4.2%	-6.6%
Smoothing analysis:									
3 year smoothed return	29.9%	23%	13%	-6%	1%	6%	28%	18%	17%
Less: Total growth rate allocated	9.5%	9.5%	10.5%	10.8%	10.8%	11.3%	11.5%	11.5%	11.5%
Less: Management expense %	0.6%	0.6%	0.8%	1.3%	1.6%	1.8%	1.8%	1.6%	1.9%
Under (Over) allocation	19.8%	13.3%	2.2%	-17.9%	-11.6%	-7.4%	14.4%	4.7%	3.4%

[35] Management's internal allocation of smoothed investment returns towards terminal bonus, which was introduced in 1973.
[36] Management's internal assessment of a required rate of return needed to support their allocations.

Bonus Distribution

D

Bonus Distribution

[Table D.3]

	1980 £m	1981 £m	1982 £m	1983 £m	1984 £m	1985 £m	1986 £m	1987 £m	1988 £m
Roll-up rate	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Declared bonus	7.0%	7.0%	7.0%	9.3%	9.3%	9.3%	8.5%	7.5%	7.5%
Guaranteed allocation	10.5%	10.5%	10.5%	12.8%	12.8%	12.8%	12.0%	11.0%	11.0%
Terminal bonus	2.8%	2.8%	2.8%	0.5%	0.5%	0.5%	0.0%	0.5%	4.0%
Total growth rate allocated	13.3%	13.3%	13.3%	13.3%	13.3%	13.3%	12.0%	11.5%	15.0%
Actual investment return	22.6%	10.8%	32.7%	22.1%	17.9%	13.9%	20.6%	8.9%	15.1%
Under (Over) allocation	9.3%	-2.5%	19.4%	8.9%	4.7%	0.7%	8.6%	-2.6%	0.1%
Smoothing analysis:									
3 year smoothed return	11.6%	12.8%	22.0%	21.9%	24.2%	18.0%	17.5%	14.5%	14.9%
Less: Total growth rate allocated	13.3%	13.3%	13.3%	13.3%	13.3%	13.3%	12.0%	11.5%	15.0%
Less: Management expense %	1.9%	1.8%	1.6%	1.6%	1.5%	1.5%	1.3%	1.4%	1.7%
Under (Over) allocation	-1.7%	-0.5%	8.7%	8.6%	11.0%	4.7%	5.5%	3.0%	-0.1%

Bonus Distribution

D

Bonus Distribution

[Table D.4]

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Allocations:												
Roll-up rate	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Declared bonus	7.5%	7.5%	6.5%	5.0%	4.0%	4.0%	4.0%	4.0%	3.0%	1.5%	1.5%	0.0%
Guaranteed allocation	11.0%	11.0%	10.0%	8.5%	7.5%	7.5%	7.5%	7.5%	6.5%	5.0%	5.0%	3.5%
Terminal bonus	9.0%	1.0%	2.0%	1.5%	5.5%	2.5%	2.5%	2.5%	6.5%	5.0%	7.0%	3.3%
Total growth rate allocated	20.0%	12.0%	12.0%	10.0%	13.0%	10.0%	10.0%	10.0%	13.0%	10.0%	12.0%	6.8%
Actual Investment Return	26.0%	-10.4%	14.4%	18.4%	28.8%	-4.2%	16.6%	10.7%	17.2%	13.3%	16.0%	2.7%
Management expense %	-1.8%	-1.8%	-1.9%	-1.5%	-1.1%	-0.7%	-0.7%	-0.6%	-0.6%	-0.5%	-0.5%	-0.8%
Under (Over) allocation	**4.2%**	**-24.2%**	**0.5%**	**6.9%**	**14.7%**	**-14.9%**	**5.9%**	**0.1%**	**3.6%**	**2.8%**	**3.5%**	**-4.9%**
Smoothing Position:												
Opening position[37]	-9.2%	-5.0%	-29.2%	-28.7%	-21.8%	-7.1%	-22.0%	-16.1%	-16.0%	-12.3%	-9.6%	-6.0%
Under (Over) allocation	4.2%	-24.2%	0.5%	6.9%	14.7%	-14.9%	5.9%	0.1%	3.6%	2.8%	3.5%	-4.9%
Closing position	-5.0%	-29.2%	-28.7%	-21.8%	-7.1%	-22.0%	-16.1%	-16.0%	-12.3%	-9.6%	-6.0%	-10.9%
% Excess aggregate policy values to available assets	5.0%	28.0%	24.6%	16.4%	1.7%	19.8%	11.9%	11.0%	7.1%	5.4%	2.8%	11.8%
Aggregate policy values in excess of available assets	245	1,375	1,539	1,299	185	2,139	1,596	1,725	1,358	2,200	734	3,057

[37] The opening smoothing position has been calculated by deducting the current year under allocation from the closing position taken from the % excess aggregate policy values to underlying assets.

Analysis of Surplus

Analysis of Surplus [Table E.1]

Actuarial Valuation: Form 58[38]	**1973 £m**	**1976 £m**	**1979 £m**	**1982 £m**	**1985 £m**	**1986 £m**	**1987 £m**	**1988 £m**
Valuation Result								
Assets	171	242	430	882	1,811	2,305	2,862	3,545
Terminal/final & interim bonuses paid	1	3	0	13	45	39	53	76
Liabilities	(150)	(213)	(373)	(754)	(1,569)	(2,186)	(2,658)	(3,361)
Gross Surplus[39]	**21**	**31**	**57**	**142**	**287**	**158**	**257**	**260**
Analysis of Surplus								
Balance brought forward	*0*	*1*	*1*	*1*	*11*	*4*	*2*	*0*
Total current surplus	**21**	**30**	**56**	**141**	**277**	**154**	**255**	**259**
Terminal/final & interim bonuses paid	(1)	(3)	(4)	(13)	(45)	(39)	(53)	(76)
Surplus available for distribution	**20**	**28**	**53**	**128**	**242**	**120**	**204**	**184**
Reversionary bonus value	(20)	(28)	(52)	(118)	(238)	(117)	(204)	(184)
Balance carried forward	*1*	*1*	*1*	*11*	*4*	*2*	*0*	*0*
% Distribution of aviable surplus	96%	98%	98%	92%	98%	98%	100%	100%

[38] These summarised valuation results are extracted from the Society's regulatory returns.
[39] Actuarially determined gross surplus is derived after taking guaranteed benefits (i.e. GIR) into account and current year terminal and interim bonus payments. From this value, reversionary bonus will be allotted and thereafter added to liabilities.

Analysis of Surplus

E

Analysis of Surplus **[Table E.2]**

Actuarial Valuation: Form 58	**1989 £m**	**1990 £m**	**1991 £m**	**1992 £m**	**1993 £m**	**1994 £m**	**1995 £m**	**1996 £m**	**1997 £m**	**1998 £m**	**1999 £m**	**2000 £m**
Valuation Result												
Assets	4,704	5,362	6,993	8,562	11,451	12,378	14,915	17,572	21,500	25,638	28,434	31,394
Terminal/final & interim bonuses paid	101	155	152	168	165	174	246	299	388	475	509	544
Liabilitics	(4,467)	(5,093)	(6,548)	(8,259)	(11,130)	(12,028)	(14,498)	(17,069)	(20,992)	(25,275)	(28,011)	(31,394)
Gross Surplus	**338**	**424**	**597**	**471**	**486**	**523**	**663**	**803**	**896**	**838**	**931**	**544**
Analysis of Surplus												
Balance brought forward	*0*	*1*	*0*	*141*	*5*	*3*	*0*	*0*	*0*	*(0)*	*(0)*	*(0)*
Total current surplus	**338**	**423**	**596**	**331**	**481**	**520**	**663**	**802**	**896**	**838**	**931**	**544**
Terminal/final & interim bonuses paid	(101)	(155)	(152)	(168)	(165)	(174)	(246)	(299)	(388)	(475)	(509)	(544)
Surplus available for distribution	**237**	**269**	**445**	**304**	**321**	**350**	**417**	**504**	**508**	**363**	**423**	**0**
Reversionary bonus value	(236)	(269)	(305)	(299)	(318)	(350)	(417)	(504)	(508)	(363)	(423)	(0)
Balance carried forward	*1*	*0*	*141*[40]	*5*	*3*	*0*	*0*	*0*	*(0)*	*(0)*	*(0)*	*0*
% Distribution of aviable surplus	100%	100%	68%	98%	99%	100%	100%	100%	100%	100%	100%	100%

[40] The inquiry has been unable to obtain an explanation regarding the magnitude of this balance carried forward.

Analysis of Surplus

E

Analysis of Surplus **[Table E.3]**

S 68 Order: Annexure[41]	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Ordinary surplus as disclosed to the Regulator	248	(161)	550	330	1,318	(745)	1,006	803	896	838	931	544
Surpluses arising from solvency margin	90	27	60	46	179	19	120	-	-	-	-	-
Exceptional items[42]	0	557	(13)	(46)	(1,015)	1,246	(462)	-	-	-	-	-
Total current surplus	337	423	597	331	481	520	663	803	896	838	931	544
Less: Cost of final & interim bonus payments	(101)	(155)	(151)	(168)	(165)	(174)	(246)	(299)	(388)	(475)	(509)	(544)
Total actuarially determined surplus	237	268	446	163	316	347	417	504	508	363	422	1
Balance brought forward	0	1	0	141	5	3	0	0	0	0	0	0
Less: Cost of new declared bonus	(236)	(269)	(305)	(299)	(318)	(350)	(417)	(504)	(508)	(363)	(423)	0
Balance carried forward	1	0	141	5	3	(0)	(0)	0	0	0	(0)	1

Gross Premium Basis - with-profits pensions:

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Roll-up rate	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Accumulation rate	5.25%	5.25%	5.25%	5.25%	3.50%	0.50%	0.50%	0.50%	0.50%	0.25%	0.25%	0.25%
	8.75%	8.75%	8.75%	8.75%	7.00%	4.00%	4.00%	4.00%	4.00%	3.75%	3.75%	3.75%
Valuation interest rate	8.75%	10.00%	10.00%	10.00%	7.25%	5.50%	5.00%	4.75%	4.00%	3.75%	3.75%	3.75%
Interest margin	**0.00%**	**1.25%**	**1.25%**	**1.25%**	**0.25%**	**1.50%**	**1.00%**	**0.75%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**
Discount factor[43]	100.0%	85.0%	85.0%	85.2%	96.5%	87.8%	91.4%	94.2%	100.0%	100.0%	100.0%	100.0%

[41] This analysis of surplus has been derived from both the Society's published regulatory return figures and internal correspondence representing the Society's S68 order applications the allowance of future profit implicit items.
[42] These exceptional items, which provide significant releases/absorption of surplus, are attributable to the interest rate differentials created by the Society over this period.
[43] The effect of the applied discount factor resulted in the Society's reported liability valuation for its with-profits business to be significantly less than that reflected in its internal office valuation which supported values contained in annual policyholder notices/statements.

Analysis of Surplus

Analysis of Surplus **[Table E.4]**

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Terminal/final & interim bonuses paid	101	155	152	168	165	174	246	299	388	475	509	544
Terminal bonus cover ratios:												
Office Valuation basis:												
Accrued terminal bonus	1,402	1,422	1,542	1,604	2,057	2,343	2,599	2,897	3,845	4,620	6,008	5,933
Years cover[44]	**14**	**9**	**10**	**10**	**12**	**14**	**11**	**10**	**10**	**10**	**12**	**11**
Companies Act Accounts basis:												
Reserves[45]	1,001	210	375	935	1,741	1,174	1,705	1,733	2,176	3,025	4,841	2,311
Years cover	**10**	**1**	**2**	**6**	**11**	**7**	**7**	**6**	**6**	**6**	**10**	**4**
Regulatory Return basis:												
Actual margin of solvency	974	413	488	843	1,717	1,168	1,697	1,733	2,123	2,524	3,861	1,632
Years cover[46]	**10**	**3**	**3**	**5**	**10**	**7**	**7**	**6**	**5**	**5**	**8**	**3**

[44] This ratio reflects the number of times (years) annual terminal and interim bonus payments are covered by accrued terminal bonus as disclosed in the Society's office valuation (Ref. Table G.5).

[45] This ratio reflects the number of times (years) annual terminal and interim bonus payments are covered by the investment reserve and later the fund for future appropriations as disclosed in the Society's statutory accounts (Ref. Table B.3 & B.4).

[46] This ratio reflects the number of times (years) annual terminal and interim bonus payments are covered by the Society's actual margin of solvency as reported in its regulatory return (Ref. Table F.1).

Regulatory Solvency

F

Regulatory Solvency: Form 9 position[47]

[Table F.1]

Analysis of Solvency/Margin Requirements	Form	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Long-term business admissible assets	58	5,805	5,933	7,452	9,565	13,382	13,551	16,503	19,131	23,828	28,238	33,111	34,257
Total mathematical reserve	9	(4,703)	(5,362)	(6,852)	(8,557)	(11,448)	(12,378)	(14,915)	(17,572)	(21,900)	(26,338)	(29,934)	(32,894)
Other liabilities	15	(128)	(158)	(112)	(164)	(218)	(256)	(154)	(139)	(176)	(226)	(241)	(731)
Available assets for required minimum margin		974	413	488	843	1,717	918	1,433	1,420	1,752	1,674	2,936	632
Plus - implicit future profits per S23 (5)		-	-	-	-	-	250	264	313	371	850	925	1,000
Actual margin of solvency	(A)	974	413	488	843	1,717	1,168	1,697	1,733	2,123	2,524	3,861	1,632
Required Minimum Margin (RMM)	(B)	204	233	293	357	458	495	586	685	846	1,008	1,114	1,221
Excess available assets: (A – B)		770	180	195	487	1,259	674	1,111	1,048	1,277	1,516	2,747	411
Regulatory cover factor: (A/B)[48]		4.77x	1.77x	1.67x	2.37x	3.75x	2.36x	2.90x	2.53x	2.51x	2.50x	3.47x	1.34x

[47] Figures are taken from the Society's published regulatory returns.
[48] The regulatory cover ratio represents the number of times the Society's actual margin of solvency covers its required minimum margin.

Regulatory Solvency F

Analysis of Regulatory Solvency [Table F.2]

	Note Ref.	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Analysis of Solvency/Margin Requirements													
Actual margin of solvency		974	413	488	843	1,717	1,168	1,697	1,733	2,123	2,524	3,861	1,632
Less: Subordinated liabilities		-	-	-	-	-	-	-	-	(346)	(346)	(346)	(346)
Restated: for subordinated liabilities		974	413	488	843	1,717	1,168	1,697	1,733	1,777	2,178	3,515	1,286
Less: Future profit implicit items	2.1	0	0	0	0	0	(250)	(264)	(313)	(371)	(850)	(925)	(1,000)
Restated: for future profit implicit items		974	413	488	843	1,717	918	1,433	1,420	1,406	1,328	2,590	286
Less: GAR reinsurance	2.2	-	-	-	-	-	-	-	-	-	(809)	(1,098)	(808)
Restated: for GAR reinsurance		974	413	488	843	1,717	918	1,433	1,420	1,406	519	1,492	(522)
Required min margin (RMM)		204	233	293	357	458	495	586	685	846	1,008	1,114	1,221
Restated cover factors:													
Revised for subordinated liabilities	2.3	4.77	1.77	1.67	2.36	3.75	2.36	2.90	2.53	2.10	2.16	3.16	1.05
Revised for implicit items	2.4	4.77	1.77	1.67	2.36	3.75	1.85	2.45	2.07	1.66	1.32	2.32	0.23
Revised for GAR reinsurance	2.5	4.77	1.77	1.67	2.36	3.75	1.85	2.45	2.07	1.66	0.51	1.34	-0.43
Regulatory cover factor		4.77	1.77	1.67	2.36	3.75	2.36	2.90	2.53	2.51	2.50	3.47	1.34

Analysis of Valuation Bases

G

Regulatory Return Basis 1989 to 2000

[Table G.1]

	Form	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Investments	13	5,638	5,698	7,207	9,267	13,142	13,221	16,230	18,876	23,512	27,874	32,725	33,768
Debtors & other assets	13	167	235	245	298	241	331	272	255	316	364	386	489
Long-term business admissible assets	13	5,805	5,933	7,452	9,565	13,382	13,551	16,503	19,131	23,828	28,238	33,111	34,257
Other liabilities	14	(128)	(158)	(112)	(164)	(218)	(256)	(154)	(139)	(176)	(226)	(241)	(731)
Net assets	9	5,677	5,775	7,340	9,401	13,164	13,296	16,349	18,992	23,652	28,012	32,870	33,526
Total mathematical reserve	9	(4,7030	(5,362)	(6,852)	(8,557)	(11,448)	(12,378)	(14,915)	(17,572)	(21,900)	(26,338)	(29,934)	(32,894)
Available assets for RMM	9	974	413	488	844	1,716	918	1,434	1,420	1,752	1,674	2,936	632

Analysis of Valuation Bases

G

Reconciliation: Return to Accounts Basis 1989 to 2000 [Table G.2]

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Net assets as per Regulatory Return	5,677	5,775	7,340	9,401	13,164	13,296	16,349	18,992	23,652	28,012	32,870	33,526
Add: Deferred Acquisition Costs	-	-	-	-	-	219	225	231	242	246	235	188
Add: Unreconciled differences	28	11	28	96	28	30	38	86	(213)	(185)	(197)	(161)
Net assets as per Statutory Accounts	5,705	5,786	7,368	9,497	13,192	13,545	16,612	19,309	23,681	28,073	32,908	33,553
Total Mathematical Reserve as per Regulatory Return	4,703	5,362	6,852	8,557	11,448	12,378	14,915	17,572	21,900	26,338	29,934	32,894
Less: Resilience reserve addition	0	0	0	0	0	0	0	0	(4000	(700)	(1,500)	(1,500)
Less: Returns: Guaranteed annuity provision[49]	-	-	-	-	-	-	-	-	-	(784)	(565)	(1,823)
Add: Accounts: Guaranteed annuity provision[50]	-	-	-	-	-	-	-	-	-	200	200	1,668
Add: Balances carried forward in the Return[51]	1	0	141	5	3	1	0	0	0	0	0	0
Add: Reconciled differences	-	[52]214	-	-	-	-	-	-	-	-	-	-
Add: Unreconciled differences	0	0	0	0	0	(8)	(8)	4	4	(6)	(8)	(154)
Technical Provisions as per Statutory Accounts	4,704	5,576	6,993	8,562	11,451	12,371	14,907	17,576	21,504	25,048	28,061	31,085

49 The Society arranged a reassurance policy with Irish European under which, if the take-up rate exceeded, pre HoL 25% and post HoL 60%, then the excess cost to the Society was recoverable from the reinsurer. The reinsurer could recover from the Society any such costs from future profits as they emerged.
50 As the provision in the Accounts was based on an assumed take-up rate below the reinsurance threshold rate of 25%/60%, no account was made of the reinsurance contract in the Accounts. These provisions were based on the Society's 'best estimated' cost.
51 The Regulatory Return carried forward balances, which are excluded from its mathematical reserves while the Statutory Accounts include these balances in its long-term business fund/provision.
52 In 1990, the Society introduced a new valuation method applied in its Companies Act accounts that resulted in no transfer between the Investment Reserve (balance sheet) and the Long-Term Revenue Account (profit & loss account) as performed in prior years. The regulator return did however reflect a transfer of £214m in excess surplus, which resulted in the difference between both liability values as shown above.

Analysis of Valuation Bases

Statutory Accounts Basis 1989 to 2000 **[Table G.3]**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Total investments	5,661	5,759	7,263	9,334	13,131	13,196	16,240	18,931	23,621	28,016	32,856	33,779
Net current assets	44	28	104	163	61	349	372	378	406	404	398	120
Subordinated liabilities	-	-	-	-	-	-	-	-	(346)	(346)	(346)	(346)
Net assets	5,705	5,786	7,368	9,497	13,192	13,545	16,612	19,309	23,681	28,073	32,908	33,553
Technical Provisions	4,704	5,576	6,993	8,562	11,451	12,371	14,907	17,576	21,504	25,048	28,061	31,085
Reserves[53]	1,001	210	375	935	1,741	1,174	1,705	1,733	2,176	3,025	4,841	2,311
Liabilities and Reserves	5,705	5,786	7,368	9,497	13,192	13,545	16,612	19,309	23,681	28,073	32,902	33,396

[53] These figures represent the Society's investment reserve to 1993 and thereafter its fund for future appropriations

Analysis of Valuation Bases

G

Reconciliation: Accounts to Office Basis 1989 to 2000 **[Table G.4]**

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Net assets as per Statutory Accounts	5,705	5,786	7,368	9,497	13,192	13,545	16,612	19,309	23,681	28,073	32,908	33,553
Less: Deferred Acquisition Costs	-	-	-	-	-	(219)	(225)	(231)	(242)	(246)	(235)	(188)
Sub-total	5,705	5,786	7,368	9,497	13,192	13,326	16,388	19,077	23,439	27,828	32,673	33,365
Add: new business loan	150	150	179	203	302	329	370	413	456	498	505	494
Add: deferred development expenditure	0	0	0	0	54	53	47	33	27	23	16	16
Less: reconciled allocation differences	-	-	-	-	-	-	-	(4)	(4)	(5)	(6)	(6)
Less: Unreconciled differences[54]		-	-	-	-	-	-	-	-	-	-	(300)
Net assets as per Office Valuation	5,855	5,936	7,547	9,699	13,548	13,708	16,804	19,520	23,918	28,343	33,188	33,569
Technical Provisions as per Statutory Accounts	4,704	5,576	6,993	8,562	11,451	12,371	14,907	17,576	21,504	25,048	28,061	31,085
Less: Accounts: Guaranteed annuity provision	-	-	-	-	-	-	-	-	-	(200)	(200)	(1,668)
Add: Office: Guaranteed annuity provision		-	-	-	-	-	-	-	-	50	50	1,500
Sub-total	4,704	5,576	6,993	8,562	11,451	12,371	14,907	17,576	21,504	24,898	27,911	30,917
Add: Unreconciled differences[55]	(6)	312	551	833	225	1,133	895	773	(73)	1,026	3	(224)
Technical provisions as per Office Valuation	4,698	5,888	7,544	9,395	11,676	13,505	15,802	18,349	21,431	25,924	27,914	30,693
Non Profit and Unit Linked liabilities	934	1,033	1,281	1,784	2,668	2,891	3,438	3,822	4,678	6,976	7,049	7,725
With profits liabilities at full value[56]	3,764	4,855	6,263	7,611	9,008	10,613	12,363	14,527	16,753	18,897	20,815	21,468
Guaranteed annuity provision	-	-	-	-	-	-	-	-	-	50	50	1,500
Accrued terminal bonus	1,402	1,422	1,542	1,604	2,057	2,343	2,599	2,897	3,845	4,620	6,008	5,933
Aggregate Policy Values as per Office Valuation	6,100	7,310	9,086	10,998	13,733	15,847	18,400	21,245	25,276	30,543	33,922	36,625

[54] The Society was unable to explain the 2000 difference of £300m.
[55] These differences are primarily considered to be attributable to discounted versus full value treatment between liability valuation basis.
[56] This represents the full value of guaranteed policy benefits and shows the aggregate value of these liabilities as communicated to policyholders by way of their individual bonus notices.

Analysis of Valuation Bases

Office Valuation Basis 1989 to 2000

[Table G.5]

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Total investments (after net current assets)	5,705	5,785	7,368	9,497	13,192	13,326	16,388	19,074	23,434	27,823	32,667	33,058
New business loan	150	150	179	203	302	329	370	413	456	498	505	494
Deferred development expenditure	0	0	0	0	54	53	47	33	27	23	16	16
Net assets	5,855	5,935	7,547	9,699	13,548	13,708	16,804	19,520	23,918	28,343	33,188	33,569
Non-Profit and Unit Linked liabilities	934	1,033	1,281	1,784	2,668	2,891	3,438	3,822	4,678	6,976	7,049	7,725
With-profits liabilities at full value	3,764	4,855	6,263	7,611	9,008	10,613	12,363	14,527	16,753	18,897	20,815	21,468
Guaranteed annuity provision	-		-	-	-	-	-	-		50	50	1,500
Technical provisions	4,698	5,888	7,544	9,395	11,676	13,505	15,802	18,349	21,431	25,924	27,914	30,693
Accrued terminal bonus	1,402	1,422	1,542	1,604	2,057	2,343	2,599	2,897	3,845	4,620	6,008	5,933
Aggregate Policy Values	6,100	7,310	9,086	10,998	13,733	15,847	18,400	21,245	25,276	30,543	33,922	36,625
Unfunded Policy Value Position	(245)	(1,375)	(1,539)	(1,299)	(185)	(2,139)	(1,596)	(1,725)	(1,358)	(2,200)	(734)	(3,057)
Aggregate with-profit policy values as a % of net assets	105%	128%	125%	116%	102%	120%	112%	111%	107%	110%	103%	112%

Analysis of Valuation Bases

G

Aggregate Policy Values: Valuation Basis Comparison 1989 to 2000 [Table G.6]

	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m	1994 £m	1995 £m	1996 £m	1997 £m	1998 £m	1999 £m	2000 £m
Regulatory Return Valuation Basis:												
Total mathematical reserve	(4,703)	(5,362)	(6,852)	(8,557)	(11,448)	(12,378)	(14,915)	(17,572)	(21,900)	(26,338)	(29,934)	(32,894)
Net assets	5,677	5,775	7,340	9,401	13,164	13,296	16,349	18,992	23,652	28,012	32,870	33,526
Funded Regulatory Position	974	413	488	844	1,716	918	1,434	1,420	1,752	1,674	2,936	632
Total mathematic reserves as a % of net assets	83%	93%	93%	91%	87%	93%	91%	93%	93%	94%	91%	98%
Statutory Accounts Valuation Basis:												
Technical Provisions	(4,704)	(5,576)	(6,993)	(8,562)	(11,451)	(12,371)	(14,907)	(17,576)	(21,504)	(25,048)	(28,061)	(31,085)
Net assets	5,705	5,786	7,368	9,497	13,192	13,545	16,612	19,309	23,681	28,073	32,908	33,553
Funded Statutory Accounts Position	1,001	210	375	935	1,741	1,174	1,705	1,733	2,176	3,025	4,847	2,468
Technical provisions as a % of net assets	82%	96%	95%	90%	87%	91%	90%	91%	91%	89%	85%	93%
Office Valuation Basis:												
Aggregate policy values	(6,100)	(7,310)	(9,086)	(10,998)	(13,733)	(15,847)	(18,400)	(21,245)	(25,276)	(30,543)	(33,922)	(36,625)
Net assets	5,855	5,936	7,547	9,699	13,548	13,708	16,804	19,520	23,918	28,343	33,188	33,569
Unfunded Policy Value Position	(245)	(1,374)	(1,539)	(1,299)	(185)	(2,139)	(1,596)	(1,725)	(1,358)	(2,200)	(734)	(3,057)
Aggregate policy values as a % of net assets	104%	123%	120%	113%	101%	116%	109%	109%	106%	108%	102%	109%

Analysis of Policy Values

H

Headdon: with-profit policy values versus assets[57] **[Table H.1]**

	APV / Assets %	APV / Assets for ave claims	With-profits APV	Claims values	Actual return	Excess claims above assets	Acc. Excess	Amount of excess APV	In force: Excess over asset shares	APV / Assets %
						[a]	[b]	[c]	[d]	[e]
	%	%	£m	£m	%	£m	£m	£m	£m	%
1989	103.4%	-	5,166	-	-	-	-	-	-	-
1990	125.8%	114.6%	6,277	572	-10.4%	73	69	1,288	1,218	124.1%
1991	122.3%	122.4%	7,805	687	14.4%	126	213	1,423	1,210	118.3%
1992	114.4%	114.5%	9,214	784	18.4%	99	361	1,160	799	109.5%
1993	101.7%	103.4%	11,065	887	28.8%	29	498	185	(313)	97.3%
1994	119.8%	105.9%	12,956	917	-4.2%	51	527	2,141	1,614	114.2%
1995	111.9%	110.5%	14,962	1,215	16.6%	115	739	1,591	853	106.0%
1996	111.0%	105.6%	17,424	1,465	10.7%	78	900	1,727	827	105.0%

Notes:

[a] the amount of claim payments each year in excess of asset share, assuming that claims have the same age distribution as the in-force.

[b] accumulation of excess claim amounts i.e. the amount by which EOY (end of year) assets would have been higher if only asset shares had been paid on claims.

[c] the amount of the excess of total policy values over assets at the end of each year.

[d] = (c) - (b), i.e. the difference between total policy values and asset shares on the in-force business viewed in isolation - that is, ignoring what has happened on claims.

[e] (d) expressed as a % of asset shares on the in-force business.

[57] Chris Headdon, the Society's appointed actuary at the time, prepared this analysis on 29 August 1997.

Analysis of Policy Values

With-Profit Policy Values versus Assets[58] **[Table H.2]**

Year	APV / Assets %[59]	APV / Assets for ave claims	With-profits APV	Claims values	Actual return	Excess claims above assets	Acc. excess	Amount of excess APV[60]	In force: excess over asset shares	APV / Assets %	Acc. excess / Assets %
	Year-end		Year-end £m	£m		(a)	Year-end (b)	Year-end (c)	(d)	(e)	
Refer to Table I	[3.1]	[3.2]	[3.3]	[3.4]	[3.5]	[3.6]	[3.7]	[3.8]	[3.9]	[3.11]	[3.11]
1989	105.0%	-	5,166	-	-	-	-	245	-	-	-
1990	128.0%	114.6%	6,277	572	(10.4%)	73	69	1,375	1,306	126.3%	101.1%
1991	124.6%	122.4%	7,805	687	14.4%	126	214	1,539	1,325	120.5%	102.8%
1992	116.4%	114.5%	9,214	784	18.4%	99	362	1,299	937	111.3%	104.1%
1993	101.7%	103.4%	11,065	887	28.8%	29	499	185	(314)	97.2%	104.7%
1994	119.8%	105.9%	12,956	917	(4.2%)	51	528	2,139	1,611	114.2%	104.2%
1995	111.9%	110.5%	14,962	1,215	16.6%	115	741	1,596	855	106.1%	105.2%
1996	111.0%	105.6%	17,424	1,465	10.7%	78	902	1,725	823	105.0%	105.5%
1997	107.1%	107.4%	20,598	1,849	17.2%	128	1,196	1,358	162	100.8%	106.2%
1998	105.4%	104.4%	23,567	2,113	13.3%	90	1,451	2,200	749	103.3%	106.6%
1999	102.8%	101.9%	26,873	2,234	16.0%	42	1,728	734	(994)	96.4%	106.9%
2000	111.8%	102.4%	28,900	2,542	2.7%	59	1,834	3,057	1,223	104.4%	106.8%
30 June 01 (year-to-date)	119.2%	115.5%	27,225	2,883	(4.7%)	387	2,126	4,377	2,251	109.0%	108.5%
Policy value reduction							(1,000)	(4,895)	(3,895)		
16% policy reduction							-	(4,265)	-		
W-P's annuities adjustment							-	(630)	-		
Restated balance							1,126	(518)	(1,644)		
Movements:											
30 June to 31 July 01	97.3%	99.0%	21,900	480	0.0%	(5)	1,121	(600)	(1,721)	92.7%	105.4%
31 July to 31 August 01	97.8%	97.8%	22,002	510	-0.7%	(11)	1,102	(485)	(1,587)	93.3%	105.3%

[58] The schedule has been prepared by the inquiry using the Society's base information and applied methodology as set out in Table H.1.
[59] Refer to Table G.5 for aggregate with-profits policy values as a % of net assets.
[60] Refer to Table G.5 for unfunded policy value position.

Analysis of Policy Values

H

Retrospective Analysis of Aggregate Policy Values[61]

[Table H.3]

	Non-GAR £m	GAR £m	Rectification £m	Total £m
In-force business @ 31 December 00				
Present value of in-force policies as at 31 Dec 00: Pre HoL	22,387	6,780	-	29,167
Net transfer value adjustment: HoL	(1,117)	962	200	45
Less: Withheld bonus [7 months @ 9% interim rate)	(1,117)	(338)	-	(1,455)
Add: GAR Provision	-	1,300	200	1,500
Present value of in-force policies as at 31 Dec 00: Post HoL	*21,270*	*7,742*	*200*	*29,212*
Terminations: 1 Jan 01 to 31 Jul 01	(2,839)	(524)	-	(3,363)
In-force business @ 31 July 01	18,431	7,218	200	25,849
Growth for 5 months @ interim bonus rate of 8% pa = 3.3% on £25,804m	645	206	-	851
Sub-total	*19,076*	*7,424*	*200*	*26,700*
16% policy reduction on 31 Dec 00 values: 16 July 01	(3,231)	(1,034)	-	(4,265)
Sub-total	*15,845*	*6,390*	*200*	*22,435*
WP annuities adjustment: 16 July 01	(630)	-	-	(630)
Sub-total	*15,215*	*6,390*	*200*	*21,805*
Add: Revised bonus rate reduction	271	67	-	338
Bonus rate reduction to fund cost of GAR: pre 16% reduction	1,117	338	-	1,455
Bonus rate reduction to fund cost of GAR: post 16% reduction	(846)	(271)	-	(1,117)
Sub-total	*15,486*	*6,457*	*200*	*22,143*
Less: Revised cost of GAR	-	(243)	-	(243)
Guaranteed annuity provision: pre 16% reduction	-	(1,300)	(200)	(1,500)
Less: Guaranteed annuity provision: post 16% reduction	-	1,057	200	1,257
Sub-total	*15,486*	*6,214*	*200*	*21,900*
Non-GAR miss-selling	220	(220)	-	-
Aggregate Policy Values @ 31 July 2001	**15,706**	**5,994**	**200**	**21,900**

Comprising:	
Aggregate policy values	20,643
GAR provision: revised	1,257
Aggregate Policy Values @ 31 July 2001	**21,900**

[61] Summary of work performed by Peter Nowell (appointed actuary) on the Society's "realistic" balance sheet, dated 21 September 2001.

Analysis of Policy Values

Aggregate Policy Values: Office Valuation Basis: With-Profits Fund **[Table H.4]**

	1999 £m	2000 £m	30-Jun-01 £m	31-Jul-01 £m
Net assets	26,139	25,843	22,848	22,500
With-profits liabilities at full value	20,815	21,468	19,670	19,303
Accrued terminal bonus	6,008	5,933	6,055	1,340
Policy Values	26,823	27,400	25,725	20,643
Guaranteed annuity provision	50	1,500	1,500	1,257
Aggregate Policy Values	26,873	28,900	27,225	21,900
(Unfunded) Funded Policy Value Position	(6,315)	(4,668)	(4,3770	600
Aggregate policy values as a % of net assets	103%	112%	119%	97%

Summary of adjustment carried out during the reduction in policy values:[62]

Assets:	
Net Assets	23,710
Less: new business loan - write off	(400)
Less: estimated previous overpayments	(1,000)
Add: miscellaneous profits	590
Add: improvement in life expectance	(400)
Net Assets	22,500
Liabilities:	
With-profits liabilities	20,643
GAR provision	1,257
	21,900
Surplus	600

[62] These financial adjustments were quantified and the adjustments made by Peter Nowell.

Analysis of Policy Values

Analysis of the 2001 office valuation basis[63]

[Table H.5]

	Total Fund		With-profits		
	30-Jun-01	**31-Aug-01**	**30-Jun-01**	**31-Jul-01**	**31-Aug-01**
	£m	**£m**	**£m**	**£m**	**£m**
Total investments (after net current assets)	30,350	28,611	22,338	22,500	21,965
New business loan	494	-	494	-	-
Deferred development expenditure	16	-	16	-	-
Net assets	**30,860**	**28,611**	**22,848**	**22,500**	**21,965**
Non-profit and unit linked liabilities	7,893	7,941	-	-	-
With-profits liabilities at full value	20,167	19,148	19,670	19,303	18,893
Guaranteed annuity provision	1,505	1,518	1,500	1,257	1,257
Face value of guarantees	**29,565**	**28,607**	**21,170**	**20,560**	**20,150**
Accrued terminal bonus	6,055	1,330	6,055	1,340	1,330
Aggregate Policy Values	**35,620**	**29,937**	**27,225**	**21,900**	**21,480**
(Unfunded) Funded Policy Value Position	(4,760)	(1,326)	(4,377)	600	485
Aggregate with-profit policy values as a % of net assets	**121%**	**106%**	**119.2%**	**97.3%**	**97.8%**

[63] Figures, including policy value estimates, provided by the Society.

Notes to the Financial Tables I

Note Ref.	Table Ref.	Comments
1.1	B.4	On 6 August 1997 Equitable Life Finance plc, a wholly owned subsidiary of the Society, issued £350m 8.0% Undated Subordinated Guaranteed Bonds which are guaranteed by the Society. The proceeds, after the deduction of costs associated with the issue, were lent to the Society on terms similar to those applicable to the Bonds. The Bonds are repayable by Equitable Life plc on a non-instalment basis on 6 August 2007 and each fifth anniversary thereafter, so long as the Bonds are outstanding.
2.1	E.2	The adjustment for future profit implicit items has been made in order to reflect the Society's reliance on this 'artificial' but allowable method of regulatory solvency support.
2.2	E.2	The adjustment to reflect the disallowance of the GAR reinsurance has been based on the premise that this reinsurance contract was not a typical reinsurance contract that transferred the risks associated with the Society's annuity guarantees sufficient to support setoff.
2.3	E.2	The actual margin of solvency restated: for subordinated liabilities balance is divided by the required minimum margin (RMM).
2.4	E.2	The actual margin of solvency restated: for future profit implicit items accumulated balance is divided by the required minimum margin (RMM).
2.5	E.2	The actual margin of solvency restated: for GAR reinsurance accumulated balance is divided by the required minimum margin (RMM).
3.1	H.2	Aggregate policy values as a % of net assets
3.2	H.2	The average of aggregate policy values as a % of net assets for the years 1990 to 1996 is taken from the Society's own calculations. Thereafter these percentages have been computed using similar methodology.
3.3	H.2	The with-profits aggregate policy value is the total of the with-profits liabilities at full value and accrued terminal bonus as disclosed in Table G.5.
3.4	H.2	The claims value for 1990 to 1996 is derived from the Society's own workings and represents the full aggregate policy value leaving the fund at the claim date. Thereafter these values have been computed using available information and applied methodology.
3.5	H.2	This represents the actual return achieved/suffered by the Society on its with-profit fund.
3.6	H.2	Based on the Society's own methodology the value of excess claims paid out above underlying assets is calculated as follows: Actual claim values are adjusted by the % derived in (note 3.2) thereby deriving the excess value of claims which were paid in excess of underlying assets.
3.7	H.2	Using the Society own methodology, the accumulated access is derived as follows: The accumulated excess brought forward from the previous year is rolled up at the current year's actual return. Added to this, is the current year claims excess, which is adjusted for an average year return.
3.8	H.2	The unfunded (aggregate policy values in excess of underlying asset values) value is taken from Table G.5
3.9	H.2	This excess value is the difference between the year-end unfunded value and the accumulated claims excess. The figure represents the portion of unfunded value attributable to in-force business.
3.10	H.2	This represents the relationship of aggregate policy values as a % of net assets attributable to in-force business and excludes the build-up of claims excesses which is included in the total excess value.
3.11	H.2	This represents the relationship between accumulated claim excesses and aggregate policy values.

Printed in the UK by the Stationery Office limited
on behalf of the Controller of Her Majesty's Stationery Office
162894 02/04